Santa Fe Southern Pacific Corporation

1985 Annual Report

Contents

Financial Highlights

	1985	1984	1983	1982	1981
					(In Millions)
For The Year					
Revenues	**$ 6,438.0**	$ 6,661.8	$ 6,017.1	$ 5,986.3	$ 6,496.7
Income from Continuing Operations, Net of Income Tax	**469.6**	490.8	333.4	307.9	491.8
Capital Expenditures	**1,078.3**	1,111.6	958.3	949.8	1,206.1
Depreciation, Depletion and Amortization	**569.1**	551.7	526.6	518.1	440.2

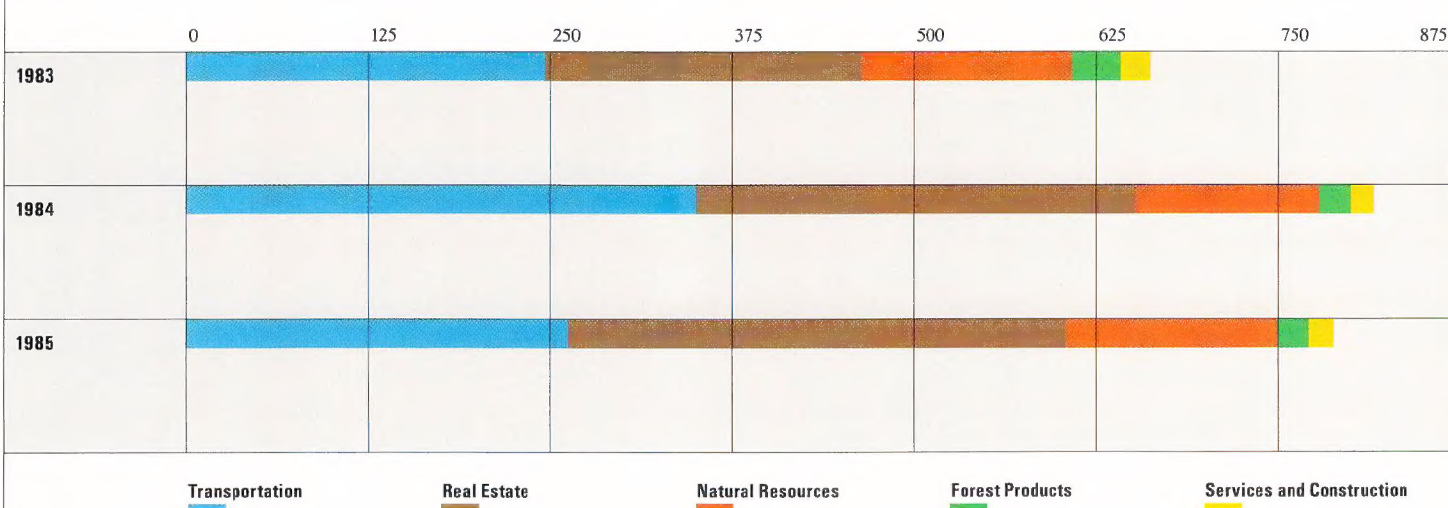
					(In Millions)
At Year End					
Total Assets	**$11,807.6**	$11,648.7	$11,387.8	$10,946.6	$10,775.4
Working Capital	**327.8**	649.0	877.4	109.9	252.4
Long Term Debt	**1,597.6**	1,668.0	1,609.4	2,178.6	2,250.0
Stockholders' Equity	**5,764.2**	5,768.5	5,740.8	5,116.2	4,989.0

Per Common Share					
Net Income					
Continuing Operations	**$ 2.67**	$ 2.61	$ 1.77	$ 1.62	$ 2.58
Discontinued Operations	—	—	2.16	.25	.11
Total	**2.67**	2.61	3.93	1.87	2.69
Stockholders' Equity	**34.05**	32.20	30.20	27.25	25.90
Cash Dividends	**1.00**	1.00	NA	NA	NA

Note: Cash dividends per share is not applicable for periods prior to December 23, 1983, the date of the business combination.

Operating Income by Business Groups

(In Millions)



To the Stockholders

I can assure you that the second year of your company's existence has proven to be as dynamic as its first. We have suffered from declining rail revenues and carloadings; declining oil and gas prices; declining forest products prices; and a softening real estate market. Despite these economic setbacks, your management team has turned in a highly creditable performance. All major business segments reported increased operating income except forest products and rail transportation. This result was achieved through careful planning and implementation of revenue generating and cost cutting programs in an atmosphere of total cooperation. Managements at both the holding company and operating company levels have jelled and are working harmoniously for your benefit.

The immediate result was a year in which our operating income declined a mere 3 percent to $788 million and our net income fell by $21 million or 4 percent to $470 million while earnings per share increased from $2.61 to $2.67, due to a lower average number of shares outstanding.

The longer term implications of our approach to managing the company may not be as apparent as the short term financial results, so I would like to discuss that approach with you now. It can be summed up succinctly in three words: "building shareholder value." That phrase is not a mere slogan around Santa Fe Southern Pacific. It is a management credo that is lived on a daily basis, and is action and result oriented. We also believe that in the long run, a program of building shareholder value should be and is synonymous with creating a stable and economically beneficial working environment for employes who, in the most direct sense, "do the job for you."

Building shareholder value is not usually accomplished by maintaining the status quo or by trying to be all things to all people. When you look closely at our company you find that we are a collection of operating companies doing business in essential industries and in a highly competitive environment. Some of our companies are well placed within their respective industries and are progressing in fine fashion—others are not. Some problems, such as those faced by our railroads and the forest products company, have been obvious for some time—others are newly developing. I am sure that 1986 will bring even more problems and challenges. Solving problems and meeting challenges is seldom accomplished by taking the easy way out. Many of the solutions are more in the nature of "biting the bullet," and all involve managerial judgments and decisions of great importance to stockholders, the public and our employes. Management must and will face and solve these problems in a reasoned way.

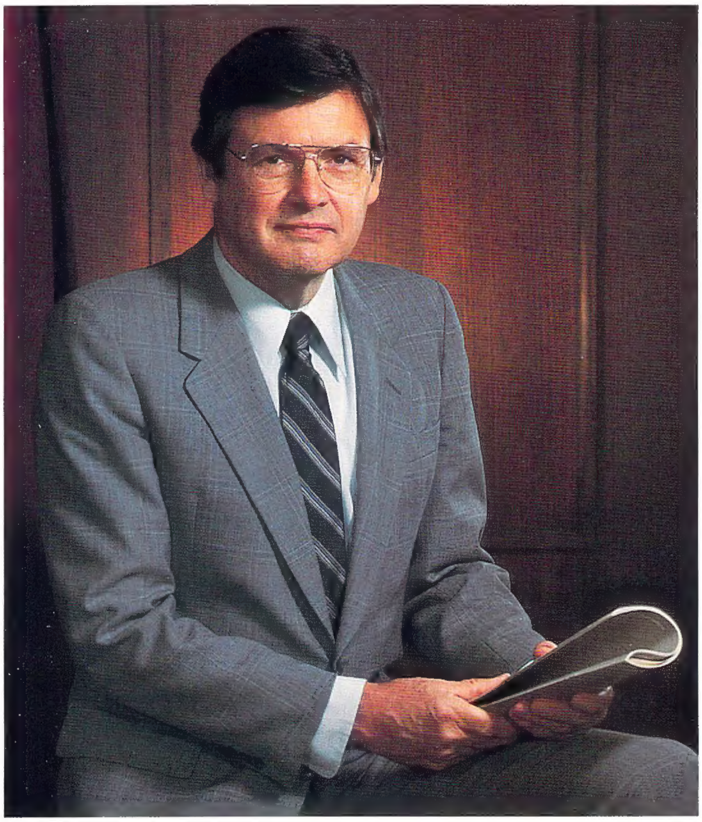
In our share repurchase program you have already seen results from our approach to building shareholder value. Since we believe our stock has been undervalued, we felt the best investment we could make was to buy back our own shares and thus enhance earnings per share of our stockholders. The Board of Directors authorized the repurchase of up to 50 million shares, and as of this writing we have repurchased a total of 20.7 million shares at an average price of $27.84. The benefit to shareholders has been the increase in earnings per share I mentioned earlier, which came about despite the decrease in net income. We plan to continue this program during 1986.

Another part of our strategy is to sell assets which are not part of the mainstream of our company and have not grown or have other problems. There are several examples of that strategy in action. During the year we closed our Walker-Kurth retail building material outlets in Texas, after determining that their potential for profitability was questionable. We have also concluded that Kirby Forest Industries doesn't fit our portfolio well, does not meet our rate of return criteria and will be a better fit in a company with a larger commitment to the forest products industry. We have, therefore, made a decision to divest all or a substantial part of the 650,000 acres of timber in Texas and Louisiana and three associated manufacturing complexes.

We are also in the process of selling or closing down Constellation Reinsurance Company, a former subsidiary of Ticor left in our portfolio after Southern Pacific Company reached an agreement to sell Ticor in 1983.

In addition to disposing of assets that don't fit well into our mainstream, a key part of our strategy is to get a better return for shareholders from assets that we regard as having long-range potential for increased earnings. In other words, we want to get more bang for the buck.

That strategy manifests itself strongly in our railroad operations, and was the driving force behind the combination of Santa Fe Industries and Southern Pacific Company. Achieving the cost savings and efficiencies necessary to improve the return from our railroads to an acceptable level is our most important goal, a goal that cannot be reached without completion of the rail merger. We can see no way that our two railroads, operating separately, can compete effectively in the long-term with the giant railroads already created in the West, or with the aggressive trucking industry. We have presented that case forcefully before the Interstate Commerce Commission, and are hopeful that the Commission will recognize the economic realities. If approval is granted without burdensome conditions, the merger will produce a strong, more competitive and cost efficient railroad, capable of providing excellent service for the shipping public and improved earnings for its shareholders. The formal case is nearly completed, and we anticipate a decision within a few months.



John J. Schmidt

The establishment of Santa Fe Energy Partners, L. P.—our oil and gas Master Limited Partnership—should enhance shareholder value in another way. Historically the market has not recognized the value of our oil and gas operations, and putting the spotlight on them through the MLP should result in a growing recognition of their value.

In real estate we have a multi-faceted strategy. We will build, lease or sell—whatever produces the best value on individual properties. We are also investigating the feasibility of establishing an MLP or similar vehicle for some of our real estate, in order to create greater value for our shareholders or to accelerate the realization of that value.

In other operations, like pipelines, mining and leasing, we have been able to increase utilization of assets and improve return through increased investments.

Our planned capital investment program for 1986 totals nearly $1.4 billion, compared with expenditures of $1.1 billion in 1985. The major portions will be devoted to rail, real estate, petroleum and pipeline operations. We are concerned about our ability to continue capital expenditures of this magnitude, which are important to our future, if some features of tax reform legislation now pending are to become law. Proposed changes in depreciation and the abolition of the investment tax credit would have a significant negative impact on our cash flow. Tax changes that would hamper the ability of American companies to keep plant and equipment modern and productive are short-sighted at best.

Stephen D. Bechtel, Jr., Chairman of Bechtel Group, Inc., and Harold J. Haynes, Senior Counsel of Bechtel Group, Inc., retired from the Board of Directors in April, 1985 to pursue other interests. Mr. Bechtel had served as a director since 1965, and Mr. Haynes since 1981. In addition, Arthur M. Wood, retired Chairman and Chief Executive Officer of Sears, Roebuck and Company, who had been a Director since 1978, retired from the Board pursuant to its retirement policy. Their valued counsel will be missed.

Lawrence Cena has announced he will retire as President and Chief Executive Officer of Santa Fe Railway effective March 31, 1986, closing out a distinguished career of more than 38 years. Mr. Cena has been succeeded as the designated president for the Southern Pacific and Santa Fe Railway, which will be created by the merged railroad, by W. John Swartz, who will also retain his position as vice chairman of Santa Fe Southern Pacific Corporation.

I regret to report that Thomas M. Orth, president of Santa Fe Energy Company, died December 14. He had served the corporation faithfully in several capacities since 1950 in the forest products and oil and gas operations and will be missed. James L. Payne was appointed to succeed Mr. Orth.

I also regret to report the death of Donald J. Russell, on December 13, 1985. Mr. Russell had retired as chairman of Southern Pacific Company in 1972 after a distinguished career spanning more than 52 years.

On behalf of the Directors, I wish to express appreciation to the officers and employes for their efforts, and to our stockholders, customers and suppliers for their loyal support.

February 26, 1986

John J. Schmidt

Chairman and Chief Executive Officer

An Interview with President Robert D. Krebs and Vice Chairmen Alan C. Furth and W. John Swartz, who answer some of the questions most frequently asked about the corporation.

Assuming the rail merger is approved, how long will it be before you begin to realize the potential benefits?

Mr. Swartz: Because of the advance planning we have been doing, we will begin to realize some of the benefits pretty quickly. For example, we will start right away to utilize the shortest route between terminals, thus reducing train miles. Also, there are some situations where personnel can be consolidated quickly, and we hope to start attracting some new business soon. It will take at least three years, though, to implement the merger fully. I'm sure we'll be realizing some benefits we haven't anticipated well beyond that.

W. John Swartz, Vice Chairman

What will be some of the major challenges in putting the two railroads together?

Mr. Swartz: As we look at what has happened in other railroad mergers, the biggest problem has usually been the people factor. After the merger there will no longer be a "Santa Fe way" or a "Southern Pacific way" of doing things —there will only be a "Southern Pacific and Santa Fe way." It takes time for people to adjust to change of any kind, and this will be no exception. We already know that both railroads have good people—frankly we think they're a cut above those at many companies and that, combined, they will make an excellent team. Our other operating companies have demonstrated that forces can be melded together smoothly, and that's what we'll be striving to do on the merged railroad, too. But it's something we have to be concerned about and plan for, and we are doing that.

I note that the refined products pipelines have been expanding rapidly. Are there prospects for future expansion?

Mr. Krebs: So far the demand to transport gasoline, jet fuel and other refined products has kept up with our expansion activities. Many portions of the refined products system are still operating at capacity much of the time. The reason is simple—we provide the service at a much cheaper rate than our highway competitors can, and the overall demand for petroleum products on the West Coast and in the Southwest is growing along with the population. We review every project carefully before we proceed to be sure that we don't over-expand, but we certainly haven't reached that point yet.

Can you sustain the high level of earnings from real estate, or is this occurring because you are liquidating your properties?

Mr. Krebs: We believe that we can sustain operating income from real estate activities at around the $300 million per year level. That doesn't necessarily mean it will be $300 million every year —real estate activities fluctuate, so some years will be better than others. You have to remember that we have a tremendous inventory of real estate in various stages of development. One of our major goals is to build annually about two million square feet of baseline properties—that's industrial, light manufacturing, research and develop-

Robert D. Krebs, President and Chief Operating Officer

ment and warehouse structures—and lease them to others. We aren't conducting a fire sale. We do have a program of selling mature properties or other properties in which we have no further plans to invest because we think that's the judicious thing to do. At the same time, we continue to look for prudent property investments in the major markets of the Southwest. Sales will continue to be an important factor in real estate results, but we expect our rental income from the baseline properties we are building to grow at a faster pace.

Why does it take so long to get major real estate projects like Mission Bay in San Francisco and the San Diego project off the ground?

Mr. Furth: These major projects are sensitive from both an environmental and a political perspective. There are often conflicting views in communities and governing bodies as to the best use for major pieces of property. It becomes a matter of negotiating with the authorities to reach agreement on land use that is acceptable to them and still returns a reasonable profit to us. Once that basic agreement is reached, it takes more time—sometimes years—to get all the various permits and approvals that are

needed before construction can begin. Then—and this is particularly true of the San Diego project right now—you have to be sure there is sufficient demand for space before you start building. This process requires a lot of patience and sometimes is frustrating, but it is normal in real estate activities.

What will happen to Santa Fe Energy if petroleum prices continue to fall?

Mr. Krebs: Falling prices would obviously have a negative impact on earnings from our petroleum operations. It should be noted, though, that we had falling prices last year and yet our operating income from petroleum production and marketing showed an increase. We have an excellent inventory of long-lived producing properties, plus a good leasehold of properties with petroleum potential, so we are better equipped to withstand price fluctuations than some companies. As prices for petroleum go down, so do costs for exploration and development, as a general rule, so that helps. It also seems inevitable that prices will recover at some point, when supply becomes more in balance with demand. Oil and gas are still finite resources, and when that balance occurs prices should rebound. We think it's still a good business to be in. There's a plus side, too. Since our two railroads use nearly two million gallons of diesel fuel a day, they benefit significantly when fuel prices drop.

What is the outlook for expansion of output at the Lee Ranch coal mine or for additional hard minerals operations?

Mr. Krebs: We anticipate about a doubling of production at Lee Ranch by the end of this decade, based on current contracts. The market is pretty flat right now, but we are hustling to find more ways to increase our sales and utilize the capacity we have at Lee Ranch. As far as other minerals are concerned, we have an excellent exploration group in our mining company, and right now they are concentrating primarily on precious metals. We have a good inventory of prospects—about 40 or so at any given time—some on our own lands and some on leased lands. The key is to come up with a prospect that can be developed into a low-cost producer, regardless of what area of mining you're talking about, so that you can withstand periods of excess capacity. We won't go ahead with new mining ventures that don't meet that criterion.

What are your plans for the Northern California Forest Products operations?

Mr. Swartz: Our people have found a nice niche in the market by catering to the individual needs of mills in their area—that is, they select logs by species and size requested, which allows the mills of our customers to operate at peak efficiency. They have also been successful in reaching out to the overseas market in the past few years. We are happy with that operation, and don't anticipate any major change.

What does the future look like for construction in the Southwest, where Robert E. McKee operates?

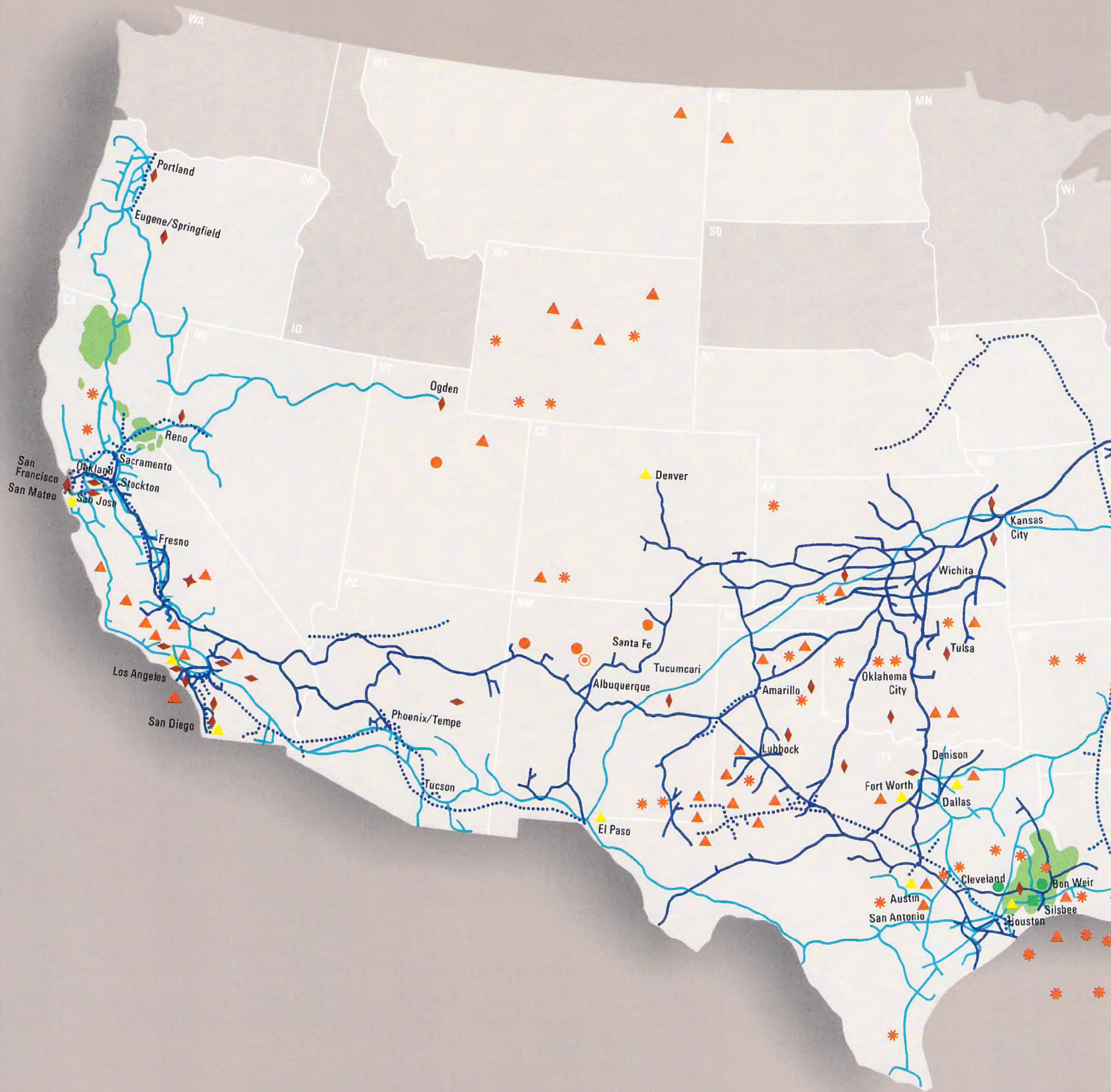
Mr. Furth: There isn't much activity in Houston, so a lot of people think the entire Southwest is in the same boat, but it's not. McKee's reputation as a quality builder, not just for general construction but especially in the high-tech and defense areas, really enhances its ability to get new contracts. As a matter of fact, the incomplete portion of work that McKee had under contract at the end of 1985 was the highest in its history. We are concentrating now on improving the margins in that operation, and increasing the scope of operations in Southern California and other areas.

Alan C. Furth, Vice Chairman

Bankers Leasing seems to be almost forgotten when people think of Santa Fe Southern Pacific. What is the outlook for that operation?

Mr. Furth: You're right, too many people overlook Bankers. It's an excellent business. They have only 51 employes, but produced $18.7 million in pre-tax income—not many companies that small can show that record. They have established a real niche in the leasing industry and that is leasing to public utilities—about 25 percent of the investor-owned utilities in the country do business with Bankers. Their customer list is growing and the number of leases outstanding is growing—they look good under just about any system of measurement you can use. We think Bankers has a good future.

SFSP Today



Transportation

- Santa Fe Rail Network
- Southern Pacific Rail Network
- Pipeline

Real Estate

- Major Undeveloped Properties
- Major Developed Properties
- Major Agricultural Holdings

Natural Resources

- Oil Production
- Gas Production
- Coal Operations
- Coal Reserves

Forest Products

- Major Forest Holdings
- Lumber and Particleboard Plant
- Plywood Plant

Services and Construction

- Bankers Leasing and Financial Corporation
- Robert E. McKee, Inc.

Santa Fe Southern Pacific Corporation's *diversified operations are centered in five major business areas: transportation, natural resources, forest products, real estate, and services and construction.*

Transportation

Rail
Rail, pipeline and truck systems provide the Company with a broad base in transportation. The Atchison, Topeka and Santa Fe Railway Company and Southern Pacific Transportation Company have applied to the Interstate Commerce Commission to combine their rail systems.

Pipeline & Truck
Pipeline systems handle refined petroleum products to customers in six Western states, natural gas liquids across Texas to the Houston area, anhydrous ammonia fertilizer from Louisiana to the Corn Belt states, and coal slurry from Arizona to Nevada. Our trucking company has authority to operate in all 48 states, but our primary operations involve transporting automobiles in the West.

Real Estate

Real estate affiliates pursue a balanced program of developing, marketing and managing properties in the West, Southwest and Midwest. Property is developed for our own account and in joint ventures for industrial, commercial and residential uses.

Natural Resources

Petroleum
Natural Resources activities include petroleum and hard minerals exploration, development, production and marketing. Petroleum operations involve onshore oil and gas exploration and development, and participation in offshore joint ventures. At year end we had 3,885 net producing oil wells and 161 net producing gas wells.

Hard Minerals
A growing income is derived from coal royalties and production. Shipments from our first coal mine began in 1984 and are expected to reach about 4 million tons per year by the late 1980s. The company has approximately 9 million acres of mineral rights in the Southwest, and an active mineral exploration program is underway.

Forest Products

Approximately 1.2 million fee acres classified as timberland are owned and managed. Southern pine plywood, lumber, particleboard and other wood products are produced from holdings in Texas and Louisiana and marketed throughout the Southwest and in Europe. Fir and pine are harvested from holdings in Northern California and marketed domestically and in the Orient.

Services and Construction

The services group includes an equipment leasing firm specializing in full-payout equipment leases, and an international treaty reinsurer of property and casualty insurance companies. Construction activities are conducted by a major general contractor that constructs office buildings, schools, airports, hospitals and industrial plants throughout the Sun Belt.

Santa Fe Southern Pacific's operating companies provide diversified services and products for the nation's economy, but share common strengths in good people, a strong asset base, excellent physical plants, and use of modern technology.

Assets *Santa Fe Southern Pacific's $12 billion portfolio is rich in land and the resources it contains. We own several million acres of property, making us one of the largest publicly-held real estate companies in the nation. Our petroleum subsidiary is one of the country's top five independent oil producers, with proved reserves of 131.3 million barrels of crude oil and 201.0 billion cubic feet of natural gas at year end 1985. We own and manage about 1.2 million fee acres classified as timberland in Texas, Louisiana and California. The company's holdings also include 791 million tons of proved and probable coal reserves—enough to meet all*

U.S. requirements for nearly one year—along with the rights to explore for coal and other minerals on millions of acres in the West. In recent years we have accelerated our program of developing these resources in a responsible manner. Real estate projects are being developed with a view to meeting the social and environmental needs of the communities where located. The Lee Ranch coal mine, opened in 1984, will provide a steady stream of income well into the 21st century, while our petroleum operations continue to replace reserves through exploration and development both on and off-shore.

Top row, left to right:
Our minerals operation includes an on-going exploration program for coal, precious, and base metals

Santa Fe Energy Co. recorded successful exploration efforts in each of its domestic districts in 1985

Our coal reserves total 791 million tons

Bottom row, left to right:
Through forest management programs, Kirby Forest Industries is able to sustain the annual yield of its timber resources

Gathering seismic data is an important step in the development of petroleum reserves

The asset base for our land company includes many excellent sites such as this one in Northern California

Physical Plant *No matter what the business, a good, sound physical plant is essential to success. Santa Fe Southern Pacific's operating companies have vast physical plants. A large percentage of our $1.1 billion capital expenditure program in 1985 was used to improve or expand those physical plants. Our facilities include two railroads which, combined, have more than 25,000 miles of track, 4,200 diesel locomotives, 104,900 freight cars and related yards and facilities. When combined, our four distinct pipelines are 5,964 miles long, and represent the third longest products pipeline system in the nation. We have 3,885 net producing oil wells, 161 net producing gas wells*

Top row, left to right:
At year end 1985, Santa Fe Energy had a total of 3,885 net producing oil wells

Storage facilities on the petroleum products pipeline handle more than 300 million barrels annually

Bottom row, left to right: The 8,750 acre Lee Ranch Mine produced over 2.1 million tons of coal in 1985

Santa Fe Railway's 110 acre intermodal terminal at Los Angeles handled over 1,000 units per day in 1985

This Santa Fe Pacific Realty complex in San Jose contains 440,000 square feet of quality office space

and extensive enhanced recovery facilities. Our Lee Ranch coal mine in New Mexico has been lauded by government officials as the most modern of its kind. We expect to construct from 2 to 2.5 million square feet of baseline properties annually for lease or rental, and our forest products operation includes three large manufacturing facilities which produce plywood, particleboard and dimension lumber.

Technology *"If you're doing anything the way you were doing it five years ago, you're probably doing it by an obsolete method." The name of the author who wrote those words has been lost to history, but the logic is something we keep clearly in mind at Santa Fe Southern Pacific. The use of technology to hold down operating expenses is critically important in today's competitive environment. Computer terminals dot not just the offices, but also the manufacturing and production facilities of all of our companies. On our railroads and pipelines, for example, computers monitor and control physical operations, improving efficiency and safety. Another computer is*

Top row, left to right:
Santa Fe Pacific Pipelines new computer system monitors and controls the flow of petroleum products

SPT's locomotive simulator is the first in the railroad industry with laser video disc visuals

Loading containers onto double-stack equipment at SPT's intermodal facility at Valla, California

Bottom row, left to right:
A mining engineer uses a computer to plan and forecast coal production at the Lee Ranch Mine

This secondary recovery plant in the Midway Sunset field in California uses steam to improve the production of crude oil

Santa Fe Railway's Division Operating Centers employ the latest computer technology to control train movements

used to train new locomotive engineers through simulation, while others control assembly lines that manufacture plywood. In our mining operations the job of stripping overburden and removing the underlying coal is first simulated by computer, to ensure that the most economical and efficient method is used. Nearly half of our oil is produced through the latest enhanced recovery techniques, such as steam drive and fire flooding, thus coaxing more oil from fields that would otherwise become depleted rapidly.

Top row, left to right:
Coal shipments account for about 20% of Santa Fe Railway's volume

Our realty staff is engaged in a balanced program of developing commercial as well as industrial properties

Intermodal traffic now produces 20% of SPT Co.'s revenues

Bottom row, left to right:
A Robert E. McKee project, Kaiser Permanente Medical Center at Woodland Hills, CA

Kirby Forest Industries produces a variety of products: plywood, particleboard, studs, and treated timber

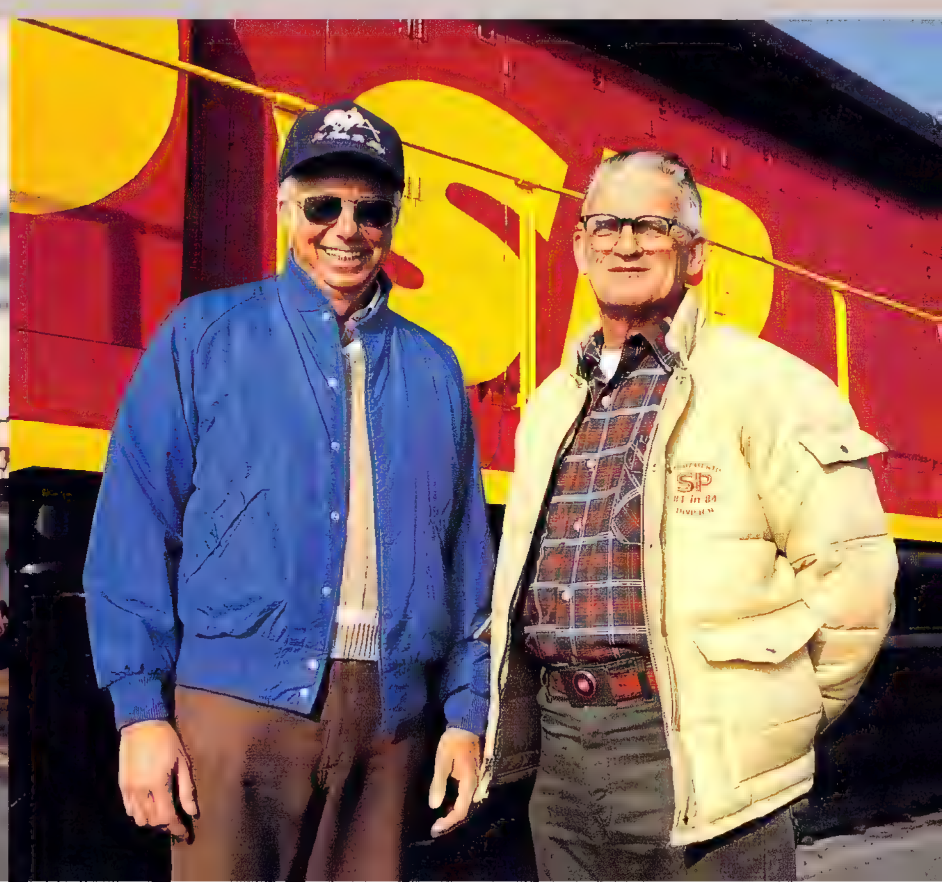
This training simulator at a nuclear power plant was leased through Bankers Leasing

A military aircraft based in Southern California receives jet fuel moved via Santa Fe Pacific Pipelines

Services and Products *Santa Fe Southern Pacific's operating companies provide diversified services and products for the nation's economy, including transportation, petroleum, hard minerals, forest products, real estate, construction and financial services. In 1985, our two railroads produced 146.8 billion ton-miles of freight service—the equivalent of carrying one ton between Chicago and Los Angeles 66.7 million times. Our pipelines carried 297.8 million barrels of petroleum products, 30.9 million barrels of natural gas liquids, 1.3 million tons of anhydrous ammonia, and 2.3 million tons of coal slurry. Our real estate subsidiary constructed 2.1 million*

square feet of new buildings for lease or rental, the petroleum company produced 18.2 million barrels of oil and 31.8 billion cubic feet of gas, while the hard minerals company produced 2.1 million tons of coal. We manufactured 662.5 million square feet of plywood, 63.5 million square feet of particleboard, and 111.8 million board feet of lumber, and completed $294.8 million worth of construction contracts. Our leasing company had a net investment of $612.0 million in equipment leased to major companies throughout the nation.

People *Schedules don't operate trains or move products through pipelines. Computers don't plant trees, produce petroleum and hard minerals, construct buildings, or manage real estate and services. It is the people of Santa Fe Southern Pacific who make things move, grow, and operate. In such a diverse organization, it takes a wide variety of people who have hundreds of different titles, but who also share a great deal in common. They are constantly involved in discovering, creating, improving, and operating. Many of our businesses don't close down at 5 p.m. or on holidays, which means that many of our people work while others relax. Although*



the nature of the activity changes from company to company, the same individual dedication is necessary if we are to provide the superior service and products our customers have a right to expect. Engineer or forester, lawyer or accountant, geophysicist or construction manager, miner or developer, they each fill separate roles aimed at a common goal—the success of Santa Fe Southern Pacific Corporation.

Top row, left to right:
Bud Ames, Supt. and Brenda Arrossa, Staff Asst., Santa Fe Mining

Barbara Barr, Attorney, SFSP Corp.

Tom Folsom, Production Foreman, Santa Fe Energy Co.

Randy Ollmann, Project Engineer, David Page, Construction Supt., Robert E. McKee, Inc.

Bottom row, left to right:
Dan Flores, Asst. General Foreman, Mechanical Dept., Santa Fe Railway

Joe Petrocchi, Engineer and Harold Lutz, Conductor, SPT Co.

Vic Hamilton, Forester, Kirby Forest Industries, Inc.

Jack Freeman, Operator, Santa Fe Pacific Pipelines, Inc.

Transportation

Rail

Hearings before the Interstate Commerce Commission on our application to merge The Atchison, Topeka and Santa Fe Railway Company and Southern Pacific Transportation Company were concluded in August, 1985. We had hoped for a decision by late 1985 or early 1986, but it now appears that the earliest the matter may be resolved will be in the late Spring or early Summer of 1986.

Current plans call for combining the two railroads immediately after the merger is approved, assuming that approval is granted without conditions that would be unacceptable. A team has been working throughout the year to refine plans for the physical operation of the merged railroad, in addition to making preparations for the changes that will be necessary in such support areas as information systems and accounting.

This advance planning should enable the merged railroad to begin achieving some economies quickly. It is anticipated, however, that three years will be required to fully implement the merger. In addition to gains from diverted rail and truck traffic to the merged railroad and the efficiencies in operation that are expected, we anticipate savings in net capital expenditures that can be avoided.

Declining volume on both railroads during 1985 underscored the necessity for the proposed merger, and the efficiencies that will result. The merger is essential to our ability to provide effective competition with the giant western railroads, as well as other modes of transportation. If the merger is approved without disabling conditions, we see a greatly improved future for our railroad operations.

In the interim, the two railroads continue to operate independently. Stock of Southern Pacific Transportation Company is being held in a voting trust while the merger application is pending. The description of that railroad's operations has been prepared by its management for inclusion in this report.

Lawrence Cena
President and
Chief Executive Officer
The Atchison, Topeka and Santa Fe Railway Company

SANTA FE RAILWAY

It was a difficult year for railway performance, reflecting the problems encountered by the nation's smokestack and agricultural industries, which traditionally have been the railroad industry's primary sources of revenue.

This changing economic picture, which coincides with growing competition from the deregulated trucking industry, was an important factor affecting rail volume during 1985. Freight carloadings and revenue ton miles each decreased about 8 percent.

Despite this significant volume reduction, Santa Fe Railway reported operating income of $145.5 million for 1985. While down 31 percent from 1984, this was a good performance in today's environment.

This result was achieved partially through a tight cost control program, including a 6.4 percent reduction in employment, and a $21 million reduction in fuel costs, reflecting both lower prices and reduced consumption. Adversely affecting results was a $9.9 million charge relating to a buy-out of rights for employes who accepted a severance or early retirement program, but this will have a positive effect on costs in the future.

Auto parts shipments, one of the few commodities to increase in 1985, were up 19 percent.

Marketing and Sales

In an important development in late 1985, Santa Fe Railway contracted with a major U. S. flag steamship line to handle containers in double-stack trains between Chicago and the West Coast. Under this contract we have retained the ability to market domestic movements of freight in the containers on the westbound leg. We have resisted the industry trend which allows steamship lines to control the westbound marketing on such trains, as that could have a negative impact on the entire westbound rate structure. We have also started offering stack container service for smaller steamship companies which cannot generate enough business for an entire train.

A joint agreement was reached with CP Rail and The Soo Line which will provide improved service between Canada and major markets in the U. S. Southwest and West Coast. The agreement calls for development of joint marketing packages and streamlined pricing and servicing arrangements among the three railroads. It offers Canadian customers more competitive access to points on the Santa Fe, and U. S. shippers will be able to serve Canadian markets more effectively.

Rail Data Santa Fe

	1985	1984	1983
Operating income (millions)	**$145.5**	$211.4	$175.7
Capital expenditures (millions)	**$397.6**	$343.3	$198.1
Carloads handled (thousands)	**1,398**	1,514	1,457
Operating ratio	**92.8%**	90.4%	91.3%
Revenue ton miles (billions)	**69.1**	75.1	67.7
Average haul per ton (miles)	**721**	737	711
Track miles of rail laid	**618**	642	149
Ties inserted (thousands)	**1,804**	1,825	930
Freight cars	**47,569**	52,393	58,075
Locomotives	**1,822**	1,888	2,001
Trailers	**7,202**	8,016	8,640

Traffic

Carloadings were down in nearly every major commodity. Of particular significance was a 25 percent reduction in grain loadings, primarily reflecting the nation's difficulty in competing in international grain markets. That decrease alone represented a loss of more than 40,000 carloads.

Coal shipments for the year were basically flat, while the number of trailers and containers moved in intermodal service was down about 4 percent. Bright spots included motor vehicles, up 4.3 percent, and vehicle parts, up 18.8 percent.

Capital Improvements

We continued our program of maintaining the physical plant and fleet in excellent condition. During 1985 we laid 408 miles of new and 210 miles of reconditioned welded rail, replaced 1.8 million ties, and resurfaced about 5,400 miles of track. We also purchased 30 new locomotive units, and remanufac-

tured an additional 120 units in our own shops.

The program planned for 1986 is similar. Fixed plant improvements anticipated include installation of 276 miles of new and 78 miles of reconditioned welded rail, insertion of 1.7 million ties and resurfacing 5,400 miles of track. The locomotive rebuilding program will continue, with 120 units scheduled for completion in 1986.

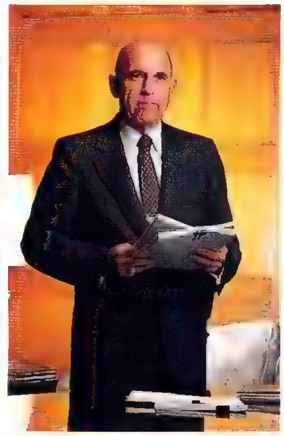
Employe Relations

For the first time in many years, an agreement was reached with a major operating union that will allow the railroad to offset increases in wage rates through moderation of restrictive work rules and elimination of duplicate payments. This agreement reflects a growing awareness on the part of unions that changes in past practices must be made if railroads are to remain an effective competitive force in the transportation industry.

In October an agreement was reached with the United Transportation Union which represents trainmen, yardmen and firemen, covering the period from July, 1984 through June, 1988. It provides for a one-time $565 lump sum payment to eligible employes, plus compounded wage increases at various intervals which total 10.9 percent over the term of the agreement.

The agreement also provides for significant wage and work rule modifications. The historic basis of one day's pay for freight train crews will be increased in steps from 100 to 108 miles. The fireman's craft will be eliminated by attrition. Many duplicate payments for duties performed are either eliminated or frozen for present employes, and eliminated for new employes. Additional through freight trains can be operated without cabooses. In 1985 more than 10.2 million train miles were operated without cabooses.

A tentative agreement with the Brotherhood of Locomotive Engineers was reached in December which largely follows the UTU agreement. Local representatives of the BLE failed to ratify the agreement, however, and it appears that a Presidential Emergency Board will study the dispute and make recommendations. Negotiations with nonoperating unions are in progress and should be concluded by mid-year.



Denman K. McNear
Chairman
President and
Chief Executive Officer
Southern Pacific
Transportation Company

SOUTHERN PACIFIC TRANSPORTATION COMPANY

Southern Pacific's railroads had operating income of $14.6 million in 1985, a decline from $51.2 million in operating income in 1984, but still above the $4.6 million recorded in 1983. The generally flat economy in 1985, coupled with stiffer competition from trucks and large merged rail systems, resulted in lower revenues.

Carloadings were down more than 6 percent to 1.52 million. Freight revenue per carload, however, was held at approximately the same level as the year before, and the 6 percent lower traffic volume was handled with 10 percent fewer manhours.

While reductions in expenses could not offset all of the revenue loss, SPT was able to trim costs in proportion to the business decline to a greater extent than had been possible in the past downturns of the industrial economy. SPT also has maintained its commitment to improving track and roadbed by continued major investments.

Iron and steel loadings increased in 1986, and new unit trains were added for crude oil and containers.

Total railroad employment was trimmed by 5 percent to 28,538 during 1985, and payroll costs were reduced by $81 million. The number of employes has been reduced by 28 percent, from 39,482, in the past five years. In 1985 SPT had a voluntary force reduction program and a severance or special retirement program involving the buyout of employes' seniority rights. The total charge was $9.2 million.

Marketing and Sales

Most major commodity groups in SPT's traffic mix showed carloading and revenue declines in 1985, as the nation's industrial economy sagged. Even intermodal shipments—the movement of containers or highway trailers on railroad flatcars, which had shown continuing growth in recent years—dropped by 7.6 percent in volume, as trucking competitors were permitted to increase trailer sizes and payloads.

Rail Data Southern Pacific

	1985	1984	1983
Operating income (millions)	**$ 14.6**	$ 51.2	$ 4.6
Capital expenditures (millions)	**$299.6**	$368.0	$290.4
Carloads handled (thousands)	**1,519**	1,619	1,537
Operating ratio	**99.4%**	98.1%	99.8%
Revenue ton miles (billions)	**77.7**	84.2	75.4
Average haul per ton (miles)	**752**	780	744
Track miles of rail laid	**526**	593	521
Ties inserted (thousands)	**1,779**	1,962	2,200
Freight cars	**57,337**	62,475	67,933
Locomotives	**2,422**	2,552	2,621
Trailers	**3,721**	3,201	3,201

Of major commodity groups, only iron and steel products showed significant gains, resulting from new movements of pipe on specially-equipped flatcars for pipeline construction projects in the Southwest, as well as unit trains of steel slab. Revenues from transportation equipment, such as new autos and trucks, gained 4 percent, and shipments of ores and concentrates, and construction aggregates in Texas, showed some gains. Government traffic, including Department of Defense and Post Office shipments, also showed improvement.

Despite the downturn in the economy's industrial sector, SPT has developed new business in some areas, including additional unit trains of crude oil in Southern California, and contracts with a foreign automobile manufacturer to handle movements from West Coast ports. In intermodal service, new unit trains of double-stacked containers are operating between California and the Midwest for three leading trans-Pacific ship lines, and expedited "Track Star" services were inaugurated over the Los Angeles-Seattle corridor in conjunction with the Burlington Northern between Portland and Seattle.

Improvement Programs

SPT has continued major programs of track replacement, equipment maintenance and capital improvements. The capital program in 1985 for roadway, yards and equipment was $300 million, and $346 million is planned for 1986.

A total of 455 track-miles of welded rail was laid, of which 209 miles were new; about 1.8 million ties were replaced, and 3,561 miles of track were resurfaced. About 53,000 track joints also were welded by new, automated equipment to extend welded rail, which provides smoother and more easily maintained track, over 187 more miles. Continuation of the programs to replace rails, ties and ballast and to weld jointed rail is projected for 1986.

Equipment acquisitions by purchase and lease included 100 gondola cars, 70 double-stack rail cars, each able to carry ten 40-foot containers, and 2,000 highway trailers for use in intermodal services. In addition, company forces rebuilt 24 diesel locomotives, 320 intermodal cars, and 245 high-roofed box cars. They also modified 358 multi-level cars used for automobile transport to improve load protection. Acquisition of 150 fully enclosed bi-level autorack cars to ship new vehicles is planned in 1986.

The largest project under way on Southern Pacific is construction of the $50 million Intermodal Container Transfer Facility in Southern California, a joint venture of the Ports of Los Angeles and Long Beach with SPT. The 150-acre yard, which will be the largest intermodal facility in the United States devoted to handling international traffic, is scheduled to open for service in the Fall of 1986. The yard will be capable of transferring 360,000 ocean-going containers a year to or from rail cars for movement in expedited, daily service between Pacific Rim nations and the Midwest, Gulf states and Eastern seaboard.

Improving Productivity

SPT will benefit from the national agreement with the United Transportation Union described in the Santa Fe Railway portion of this report. On a local basis, SPT has initiated a comprehensive program of meetings and other detailed communications with employes and their union representatives, with the aim of achieving a major reduction in labor costs through work rule changes which improve productivity and force reductions which include voluntary retirements and buyouts. SPT negotiates with 15 rail unions, and discussions are under way with all of them on agreement revisions.

SPT progressed its program to abandon unneeded and uneconomical branch lines, or to sell marginal lines to short-line operators, with the Interstate Commerce Commission authorizing abandonment of 285 miles in 1985. Authorization for abandonment of an additional 168 miles is pending. Since the program to rationalize branch lines began under provisions of the Staggers Act late in 1982, a total of 1,157 miles have been sold or abandoned, 22 percent of 1982 branch line mileage.

Pacific Motor Trucking Company was awarded a major new contract for hauling automobiles from a new assembly plant at Fremont, California.

Trucking

SPT's trucking group reported 1985 operating profit of $1.6 million, compared with $4.3 million in 1984. The decline was the result of narrow margins created by a highly competitive market environment, plus the impact of continued overhead costs during a teamsters' strike against auto carriers. The Auto Transport Division was awarded the truckaway contract at the General Motors-Toyota joint venture assembly plant at Fremont, California. The 1985 equipment program included acquisition of 100 highway truck-trailer combinations for auto transport. General commodity truck operations also were expanded in Texas, where intrastate service is one of the few remaining regulated transportation markets.

Pipeline

Santa Fe Pacific Pipelines, Inc., manages four major pipeline systems serving distinct markets. Combined they represent the third longest products pipeline system in the United States, and second largest in terms of products handled.

Our pipelines had an excellent year in 1985, producing record operating income of $100 million, an 18 percent improvement over 1984, and setting a new record for volume of refined petroleum products carried. These results are directly related to an aggressive expansion of our refined products system.

We have restructured our pipeline management along business unit lines. The resulting organization is able to manage more effectively and efficiently, with lower expense and fewer personnel, even during this period of rapid growth. We expect our pipelines to produce a steady and growing stream of operating income.

Refined Petroleum Products

Our 2,972-mile refined petroleum products pipeline system is the largest in the Western United States, serving Oregon, California, Nevada, Arizona, Texas and New Mexico. Products handled include gasoline, diesel and jet fuel for commercial and military customers. Our system handles over 40 percent of the motor gasoline consumed in California, and nearly 90 percent of that consumed in Arizona. Keeping pace with the growing markets in these expanding sunbelt areas is both a challenge and an opportunity for our pipeline system.


Raymond J. Hunt
President
Santa Fe Pacific Pipelines, Inc.

Several of our lines have been operating at capacity, with customers waiting to increase shipments as capacity became available. This prompted significant capital expenditures in 1985. Major benefits included a 20 percent expansion of capacity on our line from Southern California to Arizona, and a 30 percent increase in capacity on the line from Los Angeles to San Diego.

We installed 100 miles of 20-inch pipeline and 16 miles of 24-inch pipeline on our line to Phoenix. This was completed in October, and has resulted in a significant increase in throughput. We are now analyzing that line closely, considering the possibility of another expansion that would involve construction of an additional 256 miles of 20-inch pipeline and increase capacity an additional 40 percent. While not now budgeted for 1986, this project could go forward later in the year if demand warrants.

Our other major expansion during 1985 involved

the addition of 64 miles of 16-inch pipeline on our line from Los Angeles to San Diego, which is the major source of supply for the rapidly-growing San Diego market. Completed in mid-December, this expansion will result in a growth in business in 1986.

Several other smaller projects involving expansion of lines in Oregon and California were also completed during the year.

In addition to the possibility of further expansion of the line to Phoenix, plans for 1986 include several large expansion projects on the lines serving Central and Northern California and Nevada. These projects are designed to meet identified demand, and will add additional throughput to our system.

A new decision by the Federal Energy Regulatory Commission, now under appeal, has introduced an area of uncertainty in interstate rate matters. That ruling involves a revised method of determining what is considered to be an appropriate rate of return on pipeline investments, and could have an impact on our tariffs at some future date.

Expansions were completed on refined petroleum products pipelines from Los Angeles to Phoenix and San Diego.

Natural Gas Liquids

Our 806-mile Chaparral Pipeline delivers natural gas liquids from Eastern New Mexico and West Texas plants to fractionation facilities near Houston.

This line has been operating at about 70 percent of capacity, but our strategy of capturing new business by connecting additional gas plants to the pipeline via short laterals has proven successful and will be continued during 1986. In addition, selected tariff increases will serve to maintain adequate income levels.

Anhydrous Ammonia

Anhydrous ammonia fertilizer moves through our 1,913-mile Gulf Central Pipeline from Gulf Coast manufacturing plants to customers throughout the Midwestern Corn Belt.

Gulf Central faces increasing competition from alternate sources of nitrogen fertilizer and imported ammonia. Also of major concern is the prospect of a restrictive government farm program which would decrease grain production and demand for fertilizers.

We are exploring the potential for attracting new business by connecting with one or more terminals serving the Mississippi and Illinois Rivers through which we could move product in conjunction with barges. New pipeline tariff and storage terminal pricing changes, including selected volume discounts, are also expected to generate additional business.

Pipeline Data

	1985	1984	1983
Operating income (millions)	**$100.0**	$ 84.9	$ 74.3
Capital expenditures (millions)	**$ 81.4**	$ 42.7	$ 17.7
Refined petroleum products carried annually (million barrels)	**297.8**	293.4	271.1
Natural gas liquids transported annually (million barrels)	**30.9**	31.9	33.4
Anhydrous ammonia transported annually (million tons)	**1.3**	1.2	1.2
Coal slurry transported annually (million tons)	**2.3**	4.5	4.4

Coal Slurry

Black Mesa Pipeline, the world's largest operating coal slurry pipeline, operates under a 35-year contract to deliver coal slurry 273 miles from the Black Mesa coal fields in northeastern Arizona to a power plant in Nevada. A power plant explosion in June, 1985, caused the pipeline to be shut down the last half of the year. The plant resumed operation in December, 1985, and a return to normal operations is expected in 1986, for which delivery of 4.8 million tons of coal is forecast.

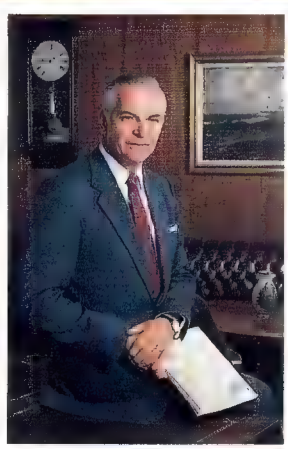
Real Estate

The mission of Santa Fe Pacific Realty Corporation is to maximize the value of assets held by the real estate company, plus properties which are no longer necessary for the operation of other operating subsidiaries of Santa Fe Southern Pacific Corporation. The mission is accomplished through staged development, investment or liquidation.

Operating income from real estate activities reached a record $341.7 million during 1985, 13 percent above the $301.6 million in 1984. Real estate results can fluctuate, but operating income at this general level appears sustainable. This consistency in results reflects our stable approach to the business, and is one of our major strengths.

The majority of our earnings now come from leasing developed properties, selling subdivided lots and liquidating properties which are in excess of our development needs. We have an expanding program of constructing buildings for lease, which is adding to our rental income, and own a number of centrally-located sites in major West Coast and Southwest cities which have significant long-range potential.

Proposed tax law changes could affect real estate activities and require changes in the way we conduct our business. Appropriate adjustments can be made, if necessary, and we do not anticipate a serious adverse impact on our operating results.



O. G. Linde
President and Chief Executive Officer
Santa Fe Pacific Realty Corporation

If the anticipated rail merger is consummated in 1986, a number of important real estate parcels may become available, stemming from redundant rail facilities. We plan to analyze those properties following the merger and begin the steps necessary to realize their development potential.

Development Activities

Development activities accelerated in 1985, when we completed or had under construction 2.1 million square feet of baseline properties—up from 1.1 million in 1984. These are industrial, light-manufacturing, research and development, low-rise office and warehouse buildings. Most are located in California, but we built our first structures in the Phoenix area and expect to begin building in the Dallas market in the near future.

Many of these buildings are built to meet specific requirements of tenants who commit in advance to lease the space. We plan to continue our expansion of this program, and expect to reach a stabilized level

where we will construct from 2 to 2.5 million square feet of such structures annually.

Industrial Park Development and Sales

We manage industrial parks located primarily in Texas, California and Arizona. We market improved lots to users and developers, and utilize some of this land for our own development activities.

The potential for some of these properties has increased considerably in recent years due to adjacent growth and development. We have reevaluated these properties, and are now preparing master plans which envision multi-use development on several sites. These include properties in Northern California, Southern California, Arizona and Texas.

Real Estate Data

	1985	1984	1983
Revenues (millions)			
Sales	**$302.0**	$278.9	$163.2
Rentals	**123.8**	114.7	104.2
Joint venture income	**6.2**	17.8	20.1
Other	**4.3**	2.1	1.3
Total	**$436.3**	$413.5	$288.8
Operating income (millions)	**$341.7**	$301.6	$217.6

Major Properties

We have significant holdings in major California cities with excellent potential, provided political and environmental problems can be solved. These projects are long range in scope, due to the time required to develop plans responsive to community and environmental needs.

We are in various stages of planning for our major holdings in the San Francisco area. This includes our 208-acre Mission Bay project, located about one mile from that city's financial district, and substantial holdings in the East Bay. The 440,000-square foot South Bay Center office complex in San Jose should be completed in early 1986, and leasing efforts have begun.

We completed or had under construction 2.1 million square feet of baseline properties in 1985.

In the 115-acre Park Del Amo project in Torrance, California, 256 residential units were completed and 243 were under contract or sold during 1985. The balance of our interest in the residential portion of this project will be sold in 1986. Approximately 220,000 square feet of commercial development was also completed in this joint venture in 1985.

With our joint venture partners we are seeking zoning approval for a 900,000 square foot, two-stage expansion of the fully-occupied Pacific Design Center in West Hollywood.

We are negotiating with joint venture partners planning construction of both hotel and office components on our 20-acre site near the waterfront in San Diego.

Resource Land Management

We are required to dispose of half of our 160,000 acres of prime farmland in California's San Joaquin Valley by 1994 under provisions of Federal Reclamation Law. We are in the process of determining a course of action for disposing of these assets in the most advantageous manner.

Several of our properties have potential for development of alternate energy sources, such as geothermal, wind or hydro power. We have concluded to limit our involvement in development of such potential to that of a royalty interest holder, rather than an active participant.

Natural Resources

Petroleum

Santa Fe Southern Pacific's exploration, production and marketing subsidiaries were faced with severe challenges during 1985 due to depressed prices and reduced demand. Despite those obstacles, the company had a very good year, with operating income increasing by 6 percent to $120.3 million. We continued our five-year trend of increasing oil production; gas production was up more than 12 percent despite unfavorable marketing conditions; and our exploration program was successful in discovering new reserves.

As one of the largest independent oil producers in the nation, we currently produce oil and gas from fields in 13 states, the Gulf of Mexico and offshore California. We actively manage a majority of our properties, directly operating wells representing 68 percent of our total production. Many of our properties are high-quality, long-lived producers. The bulk of our oil production comes from California, where we drilled our first well in 1897.

It appears that 1986 will again be a difficult year for the industry. However, since we have an excellent portfolio of producing properties, a fine inventory of exploratory acreage and a staff of high-quality professionals, we are well-equipped to cope with the near-term economic downturn in the industry.

James L. Payne
President
Santa Fe Energy Company

We have adjusted our strategy in line with current industry conditions. We will continue our aggressive exploration and development drilling program on relatively low-risk, low capital cost projects, with emphasis on oil since it is more readily marketable than gas. Projects which have high capital costs and marginal economics will be deferred until conditions improve, and we will continue to shift the emphasis in our exploration activities toward areas with a lower, full-cycle investment cost. Higher risk exploration projects in our leasehold are being promoted to other companies, thereby reducing the need for capital investment on our part but still offering the opportunity for us to share in successes. We continue to evaluate marginal properties with a view toward sales or trades. This aggressive approach to managing our business in the current economic environment should help support operating income and leave us well positioned to capitalize on opportunities that will arise when market conditions improve.

Properties

Santa Fe Energy has an excellent portfolio of oil and gas properties, both in quality and quantity.

Our undeveloped domestic leasehold acreage remained relatively constant during 1985. Several large tracts were acquired during the year, including properties in the Lower Tuscaloosa trend in Mississippi, the Mescalero Ridge in Southeast New Mexico, Paradox Basin in Colorado and Utah, and the Southern Anadarko Basin in Oklahoma. Discoveries have already been made on the first three, with exploration under way on the fourth.

We have interests in 78 blocks in the Gulf of Mexico and offshore California totaling over 100,000 net acres. We also have oil and gas exploration and development rights on approximately nine million domestic acres owned by our company or affiliated companies, a large percentage of which is situated outside of known oil and gas provinces. We actively manage that acreage considered to have the greatest hydrocarbon potential, and have been successful in negotiating agreements whereby other companies underwrite the cost of the higher-risk phase of the exploration effort.


We drilled 31.3 net exploratory wells in 1985, of which 9.3 were successful.

Petroleum Data

	1985	1984	1983
Operating income (millions)	**$120.3**	$113.4	$131.1
Costs incurred (millions)			
Acquisition of properties			
Proved	**$ 2.9**	$ 2.2	$ 19.9
Unproved	**44.4**	38.3	54.8
Exploration costs	**57.6**	62.6	47.3
Development costs	**127.0**	135.8	89.7
Total	**$231.9**	$238.9	$211.7
Crude oil production			
(thousand barrels per day)	**49.9**	48.5	47.9
Average price per barrel	**$22.20**	$22.76	$22.88
Natural gas production			
(million cubic feet per day)	**87.1**	77.5	73.1
Average price per thousand cubic feet	**$ 3.04**	$ 3.35	$ 3.51
Proved reserves			
Crude oil (million barrels)	**131.3**	135.0	138.1
Natural gas (billion cubic feet)	**201.0**	192.2	189.3
Net wells drilled			
Exploratory	**31.3**	30.3	12.3
Development	**247.4**	188.2	138.0

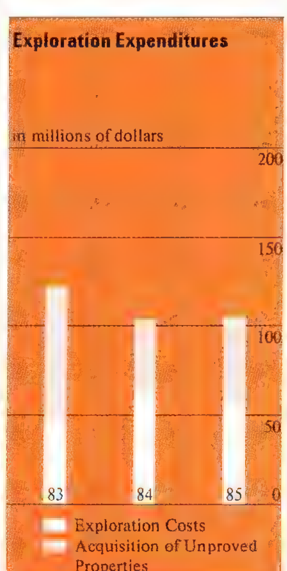
The international arena is still thought to hold significant opportunities for major reserve additions. Santa Fe Energy was an active international competitor in 1985 and successfully negotiated new concessions with the governments of Tunisia, Colombia and Indonesia. Our total foreign holdings are now 1.2 million net acres. We currently are operator of one block onshore Colombia and one block offshore Tunisia.

Exploration

We continued the same high level of exploratory activity reached in 1984 by drilling 31.3 net exploratory wells in 1985, of which 9.3 net wells were successful. A long-term, continuing exploration program is essential if a petroleum company is to remain successful since new reserves must be added consistently to replace those depleted through production.

Our 1985 exploration program registered discoveries in every domestic geographic region in which we operate. Good examples are in the Rocky Mountain district and Gulf of Mexico.

We had significant discoveries in the Sand Wash field in Colorado, and the Candy Draw field in Wyoming. Santa Fe Energy has a 50 percent working interest in the Sand Wash field where 2 successful gas wells were drilled in 1985 and where several more wells are planned for 1986. At Candy Draw, in the Powder River Basin, we have drilled 8 successful wells in which we have a 50 percent interest. Daily oil production at year end was 564 net barrels from the field. Candy Draw offers excellent potential for the application of secondary recovery techniques after primary production is completed. We also accelerated our exploration program in the Paradox Basin of Colorado and Utah with the $6 million acquisition of another company's position. Two oil fields are currently being developed in this program.



We were very successful on High Island block 105 in the Gulf of Mexico, where 1 successful exploration well and 3 successful development wells were drilled in 1985. Development of this block is continuing and we expect both oil and gas production by early 1987.

Production and Development

We increased production again in 1985, averaging 49,900 barrels of oil and 87.1 million cubic feet of gas per day, compared with 48,500 barrels of oil and 77.5 million cubic feet of gas per day in 1984. All of our current production is from fields in the contiguous U.S. and offshore.

Of significant importance is that we maintained field operating expenses in our non-thermal operations at a level below that of 1984, when calculated on an individual well basis. This contributed to our ability to maintain strong operating income during a period of soft prices.

During 1985, development drilling was conducted throughout all our areas of operations. We drilled a record 247.4 net development wells, resulting in 214.3 successful oil and 19.4 successful gas wells. In addition, at the close of the reporting period 61.1 net development wells were in various stages of completion. At year end we had a total of 3,885 net producing oil wells, up from 3,705 a year earlier, and 161 net producing gas wells, up from 141.

A significant portion of our development program was conducted in the Southern San Joaquin Valley in California, where we continued our thermal recovery program, and from which the majority of our crude oil production originated. This is an ongoing program, and continued activity is anticipated as we strive to maintain or increase production in this area, portions of which have been producing for over 80 years.

With our partners, we also continued a major tertiary carbon dioxide injection project in the Wasson Field in West Texas. This program should result in a significant increase in field production by 1987, with benefits continuing well into the next decade.

Our enhanced oil recovery activities for the year accounted for approximately 5.3 million barrels of oil being added to reserves.

Other significant activity in 1985 included the Indian Draw gas field and Mescalero Ridge oil field in Eddy County, New Mexico, as well as continued

development of various fields in Southern Mississippi and Southern Louisiana.

Reserve Additions

During 1985, we added 21.1 million oil equivalent barrels to our reserves as a result of exploratory and development operations, exceeding our results of 1984. These reserve additions very nearly replaced the production volume attained during the year and provide an excellent return on our exploration and development expenditures.

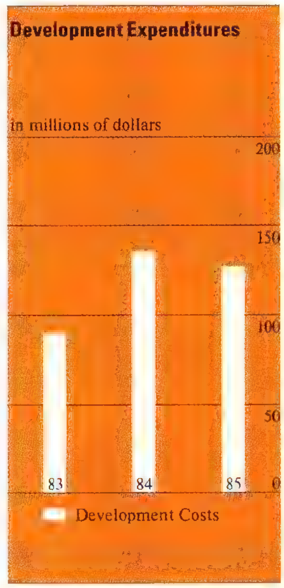
Master Limited Partnership

During 1985 we considered carefully the possibility of putting together a Master Limited Partnership for a portion of our petroleum properties. A package of properties was ultimately selected, and Units in the Partnership were marketed in early 1986 under the name, Santa Fe Energy Partners, L.P.

Included in the Partnership were properties with proved reserves, as of December 31, 1984, estimated at 166 billion cubic feet of gas and 26.3 million barrels of oil. This represents about 20 percent of the company's oil reserves and 90 percent of its gas reserves. In addition, the Partnership owns approximately one million net unproved leasehold acres.

The Partnership does not include properties and operations in and offshore California from which principally heavy oil is being produced, interest in three production units in the Wasson Field in West Texas on which tertiary recovery operations are being conducted, and certain other properties and operations. Santa Fe Energy will continue to operate those properties for its own account.

Approximately 5.75 million Units, representing 22 percent of the total Units in the Partnership, were sold on the general market, and the balance was retained. This sale generated about $106 million in cash, which was used to retire inter-company debt associated with the included properties.



The Partnership will be managed by the same staff which has been responsible for the operations of Santa Fe Energy Company and will be the predominant vehicle for the company's ongoing oil and gas exploration program.

Shareholders should benefit from the public market's growing recognition of the value of that portion of the oil and gas assets placed in the Partnership.

Marketing

World crude oil prices were soft during most of 1985 and our margins were lower as a general result. The uncertain policies of foreign oil producing nations and their impact on world oil supply cause industry observers to anticipate lower prices again in 1986.

Early in 1985, we began construction of a new crude oil terminal at Bakersfield, California, which will permit us to connect with additional pipelines and provide more flexibility in the sale of our heavy crude. This terminal will be completed in mid 1986.

Gas prices continued to slip during the year, reflecting the fact that the nation's supply currently exceeds demand. Despite this worsening business climate, we achieved a 12 percent increase in gas production, which was a major factor in our ability to maintain operating income. This growth resulted from aggressive marketing efforts, including special marketing programs with our primary purchasers and increased participation in spot market sales. We have resisted opportunities to sell a larger portion of available gas at drastically reduced prices, preferring to keep production of this valuable asset at a more conservative level until prices improve.

We expect the demand for gas to remain relatively flat in 1986, and we also expect lower prices. This depressed level of pricing has led to the addition of fewer reserves in the industry, so at some point supply should come more into balance with demand, and prices should improve.

Hard Minerals

SF Minerals Corporation enjoyed significant growth during 1985, achieving an 87 percent increase in operating income from hard minerals activities.

The major factor in that growth was our ability to benefit from having the Lee Ranch coal mine, which opened in October, 1984, in operation for the entire year.

The excellent results achieved during 1985 have focused attention on our company's growing role as a major Western coal company and a significant force in minerals exploration. For the short term, most of our revenues will continue to come from coal operations and coal royalties. We are also engaged, however, in aggressive efforts to diversify into the areas of precious metals and other minerals.

Coal

The Lee Ranch Mine, located in the San Juan Basin of New Mexico, is the newest surface coal mine in the Southwestern United States. It is the cornerstone of our hard minerals operations, and represents the first dividend from a long-range program aimed at shifting our direction from a lessor to an active operator. Prior to completion of the Lee Ranch Mine, we had derived revenues principally from rents and royalty payments under leases on our mineral properties.

Richard T. Zitting
President
SF Minerals Corporation

The mining operation is thoroughly modern, including mine planning and management information systems which are on the leading edge of technology. Coupled with a well-trained, highly-motivated work force, this has resulted in a high level of productivity. Results exceeded plans for 1985 in many significant respects. We produced more coal than anticipated, costs were lower than expected, and revenues exceeded forecasts.

Over 2.1 million tons of coal were produced during the year, more than 10 percent above the volume predicted in last year's annual report. This resulted primarily from the fact that our two principal customers, Western Fuels Association and

Tucson Electric Power, experienced a demand for electricity higher than anticipated.

At its formal dedication in April, 1985, the Lee Ranch Mine was lauded by state and federal officials as a showcase of progressive corporate policies, mining techniques and reclamation efforts. The mine is credited with bringing new life to the depressed economy of Northwestern New Mexico. At year end 166 people were employed there, with a projected work force of approximately 400 anticipated by the end of the decade.

We do not expect significant growth in coal production during 1986. By the end of 1989, however, volume from the Lee Ranch Mine to meet existing contracts is expected to grow to 3.4 million tons annually, and we expect total production that year to reach approximately 4 million tons. Sales under existing contracts could grow to 6 million tons by the mid 1990s.

Hard Minerals Data

	1985	1984	1983
Operating income (millions)	**\$26.3**	\$14.1	\$14.1
Capital expenditures (millions)	**\$ 6.9**	\$48.3	\$39.3
Proved and probable coal reserves (million tons) year end			
Leased to others	**517**	506	508
Unleased	**274**	277	273

No new coal-fired plants are scheduled to come on stream in New Mexico, Arizona, Southern California and West Texas during the 1980s. Some contracts held by other mines will come up for renewal during that period, however, and we will bid on those. Our potential market for coal sales should grow in the 1990s, if current plans for construction of new power plants are realized.

Since we own or lease nearly 250 million tons of mineable coal reserves in the Lee Ranch area, the new mine will remain productive for many years, even at increased production rates.

Our coal royalty income is also scheduled to grow. A large portion of that income, however, relates to a coal lease agreement with Texas Utilities Company, which has made all scheduled payments but is contesting the validity of the agreement. Marketing opportunities are the primary key to future expansion, although we are continuing to explore for additional coal reserves.

Over 2.1 million tons of coal were produced at the Lee Ranch Mine in 1985.

Metals and Other Minerals

Part of our strategy is to take advantage of other available mining opportunities by diversifying into metals and other minerals. Such diversification offers potential for growth and helps insulate the company from possible effects of cyclical declines in any one area.

We maintain an inventory of approximately 40 projects which are in various stages of exploration and development at any given time. Many of these projects represent potential gold or silver mines. One active project in 1985 was the McCabe Gold Mine near Prescott, Ariz., in which we hold a half-interest. We have not made a decision to date as to whether we will continue to participate in this project, but we have expensed all of our costs to date, which had an impact of \$5.3 million on earnings from our mining operations in 1985.

We have also initiated a serious evaluation of several prospects that have potential for the production of industrial minerals. In particular, we are exploring for minerals that are used as extenders, fillers, filter aids and aggregates. As reserves of such minerals are developed, we plan to establish appropriate production and marketing operations.

Our exploration activities take place primarily in the Western United States, where the company controls over 9 million acres of mineral rights, although we are also investigating attractive opportunities in other areas. Such exploration efforts are long-range by nature, as several years often pass before benefits are realized. When such programs are successful, however, the benefits can be both substantial and long-term. The Lee Ranch Mine is a prime example of such a successful program.

Forest Products

We own and manage about 1.2 million fee acres classified as timberland which provides an excellent base for our diversified forest products operations.

Kirby Forest Industries owns over 650,000 acres in East Texas and Louisiana, plus three manufacturing complexes which process timber into Southern pine plywood, lumber and particleboard. During the year we reached the conclusion to sell Kirby, provided that we can get a price commensurate with the value of the assets. The operation is not a cash drain, but returns from it have not been up to the level desired. The properties are currently on the market.

We plan to retain our 520,000 acres in Northern California which produce Douglas fir, True fir, Sugar pine and Ponderosa pine. We harvest the majority of this timber ourselves and sell delivered logs, while the balance is sold as standing timber and harvested by the purchasers.

John E. Stevens
President
Kirby Forest Industries, Inc.

Operations

Our three manufacturing plants operated efficiently and effectively during 1985. Shipments of plywood reached record levels, up 8 percent, while lumber and particleboard shipments were slightly under 1984.

Sales of logs and stumpage from our California forests reached a record high of about 207 million board feet, up 12 percent over 1984. This was an

Forest Products Data

	1985	1984	1983
Operating income (millions)	**\$20.5**	\$21.1	\$33.2
Capital expenditures (millions)	**\$11.3**	\$17.6	\$12.7
Timberland owned in fee (thousand acres)	**1,174.5**	1,174.7	1,257.4
Plywood shipped (million square feet)	**662.5**	612.2	602.1
Lumber shipped (million board feet)	**111.8**	116.3	132.3
Board feet of timber sold (millions)	**206.7**	184.3	153.2
Seedlings planted (millions)	**19.7**	16.9	14.6

exceptional year, and we expect that harvests in 1986 and subsequent years will level off at about 180 million board feet annually.

Numerous efficiencies were achieved in the production process during 1985. Of prime significance was a technological breakthrough developed by Kirby to control the drying process in plywood production. The new system improves production, results in less waste and saves energy. The designer was recognized by the U.S. Department of Energy for having achieved the most significant development in energy innovation in the forest products industry during the year.

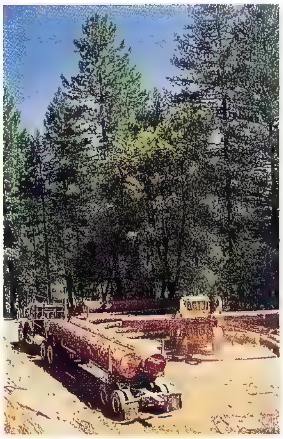
The extended depression of local housing construction and increased competition from warehouse-style home improvement centers led us to close our Walker-Kurth retail building material operation in 1985. One store was sold outright, and the remaining four were closed after inventories were liquidated. The real properties at these locations are on the market.

Marketing

Housing starts in our primary market of Houston have fallen from about 67,000 in 1982 to 13,000 in 1985. This significant reduction has created depressed prices throughout Texas, and has been a factor in holding down our operating income.

Our increased plywood shipments reflect a successful penetration of Arizona and Southern California markets. We have also expanded sales to Europe and the Caribbean. Offshore sales of plywood increased 47 percent, reaching 75 million square feet, or 11 percent of our total production. We expect continued growth in these markets.

The root cause of problems in the forest products industry is the excess structural panel manufacturing capacity created during the boom period of the late 1970s. Although the industry produced near-record levels of panel products in 1985, it was operating at only about 80 percent of capacity. This problem should disappear gradually as older, less-efficient plants are retired.



Sales of logs to Japan and China totalled 14 million board feet in 1985.

Logs harvested from our California forests are sold primarily to mills in Oregon and Northern California. We cater to individual customers by selecting logs by species and size requested, which allows their mills to operate at peak efficiency.

We also market logs to Pacific Rim countries from our California forests. Sales in 1985 to Japan and the People's Republic of China were 14 million board feet, slightly under 1984. This still represents a growing market, but we are facing increasing competition from other forest products companies whose resources exceed their manufacturing needs.

Resource Management

We carry out a prudent management program designed to perpetuate our timberland assets. We endeavor to increase the annual harvest while carrying out programs designed to expand the amount of fiber available for future harvests. Our modern seedling nursery in Texas produces all of the high-quality plants needed for our Southern reforestation.

We planted 17.4 million seedlings on our Southern plantations in 1985, and 2.3 million in California. We plan to continue the program at about that level. A large portion of the California properties are mountainous and do not lend themselves to the plantation approach practiced in the South.

The Landowners Assistance Program was continued in 1985, and now includes more than 58,000 acres, intermingled with our Southern holdings. Under this program we manage timber properties owned by others, and obtain the right of first refusal at harvest time. Landholders benefit from our expertise in forest management, and we are able to expand the volume of fibers available for our needs without extensive capital investments.

Services and Construction

Bankers Leasing and Financial Corporation achieved excellent results in 1985. A relatively small, low-cost organization of 51 employes, Bankers recorded pretax income of $18.7 million, a 9 percent improvement over 1984. Another milestone was reached in 1985, as net investment in leases outstanding reached $612.0 million, compared to $555.2 million a year earlier.

Bankers' success in the highly competitive leasing industry stems from an operating philosophy that includes four important ingredients. First, the company carefully controls its credit risks, as it deals only with high-quality corporate customers. Second, it minimizes interest rate risks by matching financing arrangements with lease agreements. Third, it takes no inventory risks, as investments in equipment are not made until a customer for that equipment is in place. Fourth, it selectively targets its marketing efforts to emphasize areas where it can add value for its customers.

We have leasing agreements with approximately 150 leading domestic corporations. These leases involve about 85,000 units of equipment, ranging from motor vehicles, railcars, computers, and corporate aircraft to equipment used in the mining, communication and construction fields.

Bernard Goldman
President
Bankers Leasing and Financial Corporation

We tailor lease programs to the financial and operating needs of individual corporate clients. Lease terms may be short, intermediate or long-lived, and can be subject to a floating or a fixed lease rate.

Investments are made to suit the particular needs of individual customers. Because of this policy, every asset in the portfolio is under lease to a high-quality company which has committed itself to lease that asset for a specified period of time. Under most agreements, lessees can continue to acquire and terminate the use of leased equipment within an established investment limit. As assets are terminated from leases, they are generally replaced by new assets of a similar kind.

We have been especially successful in leasing assets to investor-owned utility companies, and this market represents more than 75 percent of our business. Bankers currently has as clients about

25 percent of the investor-owned utility companies in the United States.

Bankers' strategy for the future calls for growth. We anticipate a continued expansion of leases with present customers, and a growing penetration of the utilities market. We are also seeking additional penetration of the industrial market and are directing new emphasis to that activity.

We executed 25 additional leasing agreements valued in excess of $163 million during the year, of which 9 were with new customers.

Potential changes in tax laws should have a minimal impact on Bankers' operations. Its leases have always been structured to be attractive from a general business and financial approach, rather than being driven by tax considerations. There could be some impact if new tax laws affect the level of investment customers make in new equipment.

Construction

Robert E. McKee had another record year in 1985. The $321.7 million in new contracts awarded was up 17 percent over the previous year, and work completed was up 18 percent.

Ranked among the top 50 general contractors in the nation, McKee focuses on five distinct markets throughout the West and Southwest. These include: public works ranging from federal to local projects; hospitals and healthcare facilities; high tech research/manufacturing plants for electronic manufacturers; hotels, offices and other properties for commercial/corporate real estate developers; and light industrial manufacturing/distribution facilities.

McKee's marketing philosophy is to focus on current and potential clients that are leaders in their particular fields, are financially sound and are in a growth mode. Such clients present the best potential for multiple contracts, which often result from McKee's track record as a high-quality, safety-conscious contractor that completes work on time and within budget.

Major contracts completed or under way in 1985 include a million-square foot high tech facility in Dallas for a defense contractor; major high-rise office and parking garage complexes in Dallas and Phoenix; wastewater treatment plants in Denver and El Paso; airport renovation projects in Denver; and major hospital facilities and medical centers in Dallas and Woodland Hills, California. McKee is also constructing a number of large defense-related high tech facilities in Austin, Texas and in several Southern California locations.

The uncompleted portion of work in progress at year end of $261.6 million was up 11 percent over the previous year, so the company is primed for another good year in 1986. While there may be some softening in the commercial construction area in 1986, the overall potential for new contracts appears favorable, especially in the public works sector.

Mason Brown
President
Robert E. McKee, Inc.

Services Data

	1985	1984	1983
Assets acquired for lease	**$196.9**	$217.6	$193.9
Net investment in lease	**$612.0**	$555.2	$510.2
Value of leases completed	**$163.2**	$258.8	$200.1

Construction Data

Incomplete portion of contracts in progress January 1 (millions)	**$234.7**	$210.7	$222.4
New contracts	**321.7**	274.2	201.1
Work completed	**(294.8)**	(250.2)	(212.8)
Incomplete portion of contracts in progress December 31	**$261.6**	$234.7	$210.7

Financial Review

Twelve Months Ended December 31	1985	1984	1983	1982	1981
					(In Millions)
Revenues by Business Groups					
Forest Products	$ 204.4	$ 233.3	$ 241.2	$ 193.3	$ 179.5
Natural Resources					
Petroleum Production and Marketing	516.9	515.7	510.9	545.9	495.9
Hard Minerals	92.5	31.4	23.5	20.2	16.5
Real Estate	436.3	413.5	288.8	233.9	186.6
Services and Construction	286.4	237.9	228.7	231.7	220.7
Transportation					
Rail					
Santa Fe	2,146.6	2,303.7	2,081.8	2,061.2	2,349.8
Southern Pacific	2,464.5	2,649.1	2,363.8	2,377.5	2,695.2
Pipeline	209.1	193.4	172.7	172.6	160.8
Truck	81.3	83.8	105.7	150.0	191.7
Revenues	$6,438.0	$6,661.8	$6,017.1	$5,986.3	$6,496.7
Operating Income by Business Groups					
Forest Products	$ 20.5	$ 21.1	$ 33.2	$ 15.7	$ 23.5
Natural Resources					
Petroleum Production and Marketing	120.3	113.4	131.1	130.7	136.1
Hard Minerals	26.3	14.1	14.1	11.4	9.1
Real Estate	341.7	301.6	217.6	172.1	138.8
Services and Construction	17.2	14.9	18.8	23.7	20.6
Transportation					
Rail					
Santa Fe	145.5	211.4	175.7	134.8	286.2
Southern Pacific	14.6	51.2	4.6	(6.9)	149.2
Pipeline	100.0	84.9	74.3	73.4	66.5
Truck	1.6	2.1	(8.8)	(17.6)	(20.5)
Operating income	$ 787.7	$ 814.7	$ 660.6	$ 537.3	$ 809.5

Santa Fe Southern Pacific Management's Discussion and Analysis of Financial Condition and Results of Operations

Results of Operations

1985 Compared With 1984

Net income of Santa Fe Southern Pacific Corporation ("SFSP") declined by 4% in 1985 to $469.6 million, despite an improvement in earnings during the second half of 1985. The lower results were attributable to a substantial reduction in operating income at both of the company's railroads and decreased Other Income-Net, which more than offset improved earnings from most of the company's other business segments. Net income per share, however, rose by 2%, to $2.67 a share as compared with $2.61 in 1984, reflecting the effects of the company's share repurchase program.

Operating income from the transportation group in 1985 totaled $261.7 million, a decrease of $87.9 million from the previous year. This change was the result of a $102.5 million reduction in operating income from rail activities, partially offset by higher pipeline operating income. For 1985, operating income attributable to rail operations totaled $160.1 million, as compared to $262.6 million in 1984, due to reduced rail volumes. These results include the operations of both The Atchison, Topeka and Santa Fe Railway Company ("Santa Fe Railway") and the Southern Pacific Transportation Company ("SPT"), whose common stock is presently held in an independent voting trust pending Interstate Commerce Commission approval of its merger with Santa Fe Railway. See Note 2 of "Notes to Financial Statements" for further information regarding the business combination.

Santa Fe's rail operations produced operating income of $145.5 million, a decrease of $65.9 million from 1984. This reduction was principally due to a $157.1 million or 7% decrease in operating revenues resulting from an 8% decline in carloadings. During 1985, carloading reductions were experienced in all major commodity groups other than coal and vehicles and parts. The decline in revenues was offset, in part, by a $91.2 million or 4% decrease in operating expenses. The reduced expense levels were due to the lower volumes and cost control programs instituted in recent years.

For 1985, SPT's rail operations reported operating income of $14.6 million, down from $51.2 million a year ago. Like the Santa Fe Railway, SPT rail reported a 7% decline in operating revenues, which fell to $2,464.5 million, primarily due to a 6% reduction in carloadings. During 1985, carloadings of all major commodity groups other than grain and chemicals were adversely affected. Operating expenses attributable to SPT rail activities decreased by 6% to $2,449.9 million as the result of the lower volumes and cost containment efforts.

Operating income from pipeline activities totaled $100.0 million, an increase of $15.1 million or 18% from 1984. The improved earnings from pipeline operations resulted principally from increases in both the volume and tariff for refined petroleum products transported on the company's Southern Pacific Pipe Line and from higher operating income produced by Gulf Central Pipeline Company. Gulf Central benefited from increased product volume, higher prices and a $1.3 million reduction in general and administrative expenses.

Real estate operations, the company's largest contributor in 1985, produced operating income of $341.7 million, an increase of $40.1 million or 13% over 1984. The majority of this improvement resulted from increased land sales, primarily in California and the Southwest. Real estate operations also generate substantial revenues from rental properties and joint venture activities, which comprise approximately 30% of total real estate revenues.

Operating income from petroleum production and marketing operations rose by $6.9 million in 1985, to $120.3 million. The principal reason for this improvement was a $5.7 million decrease in petroleum operating expenses, which resulted from a $16.8 million decline in proved property impairments (additional depreciation and depletion) and a $14.0 million decrease in Windfall Profit Tax. These expense declines were partially offset by higher depreciation, depletion and amortization, due to increased production and a higher asset base, and increased petroleum production costs. Operating revenues of $516.9 million were approximately the same as last year. Average daily oil production in 1985 was 49,900 barrels per day, up 3% from 1984, while the average price realized decreased by 2% to $22.20 per barrel as compared with $22.76 in 1984. Natural gas production for the year rose by 12% to 87.1 million cubic feet per day, while the average price realized, reflecting unfavorable market conditions, decreased by 9% to $3.04 per thousand cubic feet as compared with $3.35 a year ago.

Hard minerals operating income was $26.3 million versus $14.1 million a year earlier. The increase resulted from the inclusion in 1985 of a full year's operation of the Lee Ranch Mine, which commenced production in late 1984. Partially offsetting this was an increase of $11.1 million in exploration and development expense, which included the write-off in 1985 of $5.3 million of costs related to a gold mining project.

Operating income from the forest products group totaled $20.5 million, slightly less than the $21.1 million reported in 1984.

Services and construction activities for 1985 reported operating income of $17.2 million, an increase of $2.3 million over 1984. The increase was primarily due to a $1.5 million improvement in operating income from leasing activities and slightly higher earnings from construction operations.

Other income for the year totaled $16.1 million, a decrease of $56.9 million from 1984. The decrease principally resulted from a significant reduction in interest income attributable to lower levels of cash and temporary investments and increased losses from reinsurance operations.

Federal income tax expense decreased by $56.3 million, to $182.9 million. This decrease occurred principally as the result of a decline in 1985 pre-tax income and from a lower effective tax rate which was attributable to a higher proportion of capital gain income to total income in 1985 compared with 1984.

1984 Compared With 1983

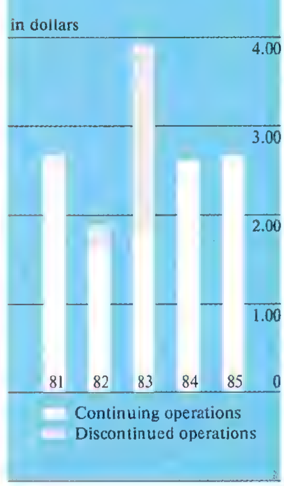
As a result of significant increases in operating income from transportation and real estate activities, net income from continuing operations for 1984 rose by 47% over 1983 to $490.8 million. Revenues were $6.7 billion, up 11 percent from the $6.0 billion reported for 1983. Net income was $249.1 million lower than last year; however, 1983 included $406.5 million in income from discontinued operations, primarily reflecting the sale of the company's communications operations.

Operating income from the transportation group totaled $349.6 million, an increase of $103.8 million or 42% over 1983. This improvement largely resulted from an $82.3 million increase in operating income from rail activities.

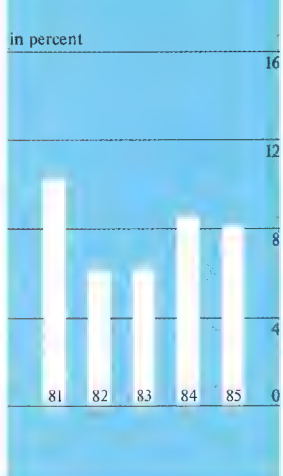
Santa Fe's rail operations reported operating income of $211.4 million, an increase of $35.7 million over 1983. This improvement was principally due to a $221.9 million increase in operating revenues, resulting largely from a 4% increase in carloadings and higher average revenue per carload. Significant increases were experienced in grain, coal and chemical shipments. Commodities showing decreases were food and farm products and lumber products. The improvements in revenues were offset, in part, by a $186.2 million increase in operating expenses, principally as a result of the higher rail volume and increased maintenance expense for both track and equipment.

Southern Pacific's rail operations produced operating income of $51.2 million, an improvement of $46.6 million from 1983. The increase was due to a 12% increase in operating revenues. The improved rail volume was reflected by a 5% increase in carloadings and a 7% increase in average revenue per carload. Important increases were experienced in shipments of vehicles and parts and intermodal, while decreases occurred in lumber products and grain. Operating expenses of SPT reflected the increased activity levels of 1984, as they rose by $238.7 million. The most significant increases were $131.1 million in transportation expenses and $94.5 million in equipment maintenance costs.

Net income per share



Return on stockholders' equity from continuing operations



Increases in operating income also were reported by the company's pipeline and trucking operations. Operating income from pipeline activities of $84.9 million increased by $10.6 million or 14% from 1983, primarily due to increases in both the volume and price of products transported on the company's Southern Pacific Pipe Lines system. Black Mesa and Gulf Central pipelines also experienced increases in throughput. Operating income from trucking operations totaled $2.1 million, a turnaround of $10.9 million from 1983. This increase in earnings reflected the discontinuance by Pacific Motor Trucking Company of certain unprofitable operations late in 1983.

Real estate operations continued to be the company's second largest contributor, with operating income of $301.6 million, an increase of 39% over the previous year. This improvement came mostly from increased land sales activity, which generated revenue of $278.9 million, up 71%, and increased rental income, partially offset by higher land sales costs. The most significant sales during 1984 occurred in California, Texas and Arizona.

Operating income from petroleum production and marketing activities for 1984 totaled $113.4 million, a decrease of $17.7 million from 1983. The change in earnings was primarily due to increased operating expenses and lower average prices realized for both oil and gas, partially offset by higher levels of production. Operating expenses attributable to petroleum operations increased by $22.5 million during 1984, due to a $10.9 million increase in proved property impairments, a $10.6 million increase in depreciation and depletion expense resulting from higher crude oil production and a higher asset base, and increased production expenses. These changes were offset by a $5.0 million decrease in Windfall Profit Tax expense resulting from lower crude oil prices. Average daily oil production during 1984 was 48,500 barrels, up slightly from 47,900 in 1983, while the average price realized decreased slightly to $22.76 per barrel as compared with $22.88 per barrel in the previous year. Natural gas production rose by 6% to 77.5 million cubic feet per day, while the average price realized, reflecting unfavorable market conditions, decreased by 4.6% to $3.35 per thousand cubic feet as compared with $3.51 in 1983.

Hard minerals operating income in 1984 was $14.1 million, equaling the record earnings achieved by that activity in 1983. During the fourth quarter of 1984, operations began at the Lee Ranch Mine in New Mexico. Shipments of coal were minimal in 1984, but they are expected to reach about 1.9 million tons during 1985. Volume is expected to increase to 4 million tons by the late 1980's.

Operating income from the company's forest products operations was $21.1 million, down from the $33.2 million produced in 1983. This decrease was primarily the result of reduced single-family

housing starts in that segment's principal marketing area of Texas. Also, strong competition from foreign products resulted in reduced shipments of lumber, decreased plywood and lumber prices and lower retail sales.

Services and construction activities recorded operating income of $14.9 million, a reduction of $3.9 million from 1983. The decrease was primarily due to higher construction operating expenses and the recognition during 1984 of losses on several construction contracts, partially offset by slightly higher operating income from Bankers Leasing.

Other income rose by $55.6 million, resulting from a significant increase in interest income from higher levels of cash and temporary investments. Also, 1983 results include $18.4 million in merger-related costs and $17.0 million in charges for discontinuing unprofitable trucking operations.

Interest expense for 1984 decreased by $13.4 million to $123.3 million. The decrease was principally due to lower levels of debt outstanding during most of 1984 and a $4.3 million increase in capitalized interest cost.

Financial Condition

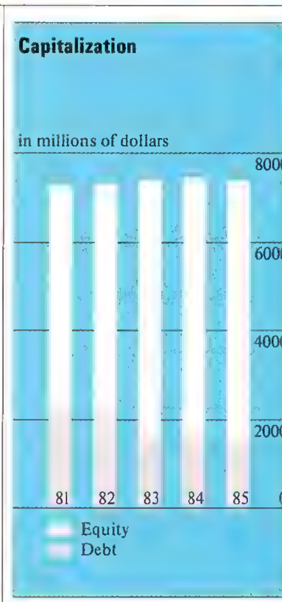
The financial condition of Santa Fe Southern Pacific Corporation as of December 31, 1985 is reflected by the balance sheet presented on page 34.

Cash provided by operations, including both continuing and discontinued operations, as shown on the statement of changes in financial position presented on page 35 was $1,294.5 million in 1985, $1,520.2 million in 1984 and $1,743.9 million in 1983. These amounts were more than sufficient to cover capital expenditures and dividend payments made in each of the three years 1983 through 1985.

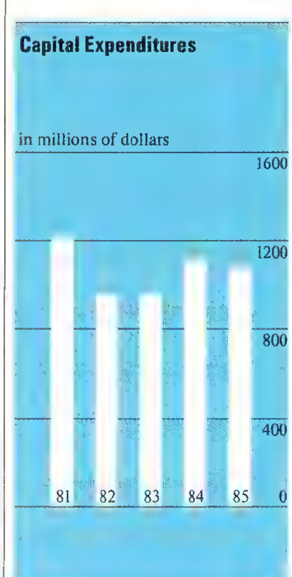
Capital expenditures for 1985 were $1,078.3 million, compared with $1,111.6 million for 1984 and $958.3 million for 1983. In each of these periods a substantial portion of these expenditures has been for oil and gas exploration and development, and improvements to rail equipment, track structure and roadway. During the past three years, the majority of these expenditures were provided through internally generated funds.

Long term debt, including current maturities, decreased during 1985 to $1,794.4 million, down from $1,816.1 million at the end of 1984, but slightly higher than the $1,776.8 million outstanding at the end of 1983. As of December 31, 1985, Santa Fe Southern Pacific Corporation and its consolidated subsidiaries had unused bank lines of credit aggregating $310.0 million.

Dividends paid to stockholders in the years 1983 through 1985 represented 50%, 38% and 37%, respectively, of earnings from continuing operations. The current annual dividend rate is $1.00 per share.



Capitalization



Capital Expenditures

During 1985, approximately 10 million shares of Santa Fe Southern Pacific common stock were repurchased at a cost of $302.1 million. Since the inception of the stock repurchase program in 1984, approximately 21 million shares of SFSP common stock have been repurchased at a cost of $577.2 million. The board of directors of Santa Fe Southern Pacific Corporation has authorized the repurchase of up to 50 million shares of the company's common stock in order to provide shares for various corporate purposes.

As of December 31, 1985, SFSP's current ratio was 1.23 to 1 compared to 1.47 to 1 last year, and the ratio of long term debt to total capitalization was 21.7% compared with 22.4% at December 31, 1984. Working capital at December 31, 1985 was $327.8 million, a decrease of $321.2 million from year end 1984, and substantially lower than the $877.4 million at the end of 1983. The decrease in working capital during 1985 occurred principally as the result of 1985 treasury stock purchases.

Stockholders' equity per share at December 31, 1985, 1984 and 1983 was $33.97, $32.20 and $30.20, respectively.

Considering the company's present liquidity and capitalization as well as credit availability, it is management's belief that Santa Fe Southern Pacific will be able to fund the future growth of the company from internally generated funds and, if necessary, external financing under relatively favorable terms.

Effects of Inflation

For supplemental information relating to the effects of changing prices, see Note 18 to Santa Fe Southern Pacific's Consolidated Financial Statements.

Common Stock Market Prices and Dividends

Santa Fe Southern Pacific common stock is traded on the New York, Midwest and Pacific Stock Exchanges. The quarterly price range per share for the years 1985 and 1984 is as follows:

	1985		1984	
	High	**Low**	High	Low
First Quarter	**30 5/8**	**24 1/2**	26 3/8	21
Second Quarter	**34 1/4**	**25 1/8**	25 3/8	20 1/4
Third Quarter	**35 3/8**	**31**	26 5/8	20 3/8
Fourth Quarter	**37 1/8**	**31 1/8**	26 5/8	23 3/8

In 1985 and 1984, the quarterly dividends were $.25 per share. As of January 31, 1986, there were approximately 117,000 holders of Santa Fe Southern Pacific common stock.

Report of Independent Accountants

To the Stockholders, Chairman and Board of Directors of Santa Fe Southern Pacific Corporation

We have examined the consolidated balance sheet of Santa Fe Southern Pacific Corporation and subsidiary companies as of December 31, 1985 and 1984, and the related consolidated statements of income, stockholders' equity, and changes in financial position for each of the three years in the period ended December 31, 1985. Our examinations were made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As discussed in Note 2, the accompanying financial statements include the assets and operations of the trusteed Southern Pacific Transportation Company. These financial statements do not include adjustments which may be necessary should the Interstate Commerce Commission require disposal of a portion of Santa Fe Southern Pacific Corporation's railroad and trucking assets and operations.

In our opinion, subject to effects on the financial statements of such adjustments, if any, as might have been required had the outcome of the matter referred to in the preceding paragraph been known, the financial statements examined by us present fairly the financial position of Santa Fe Southern Pacific Corporation and its subsidiary companies at December 31, 1985 and 1984, and the results of their operations and changes in their financial position for each of the three years in the period ended December 31, 1985, in conformity with generally accepted accounting principles consistently applied.

Price Waterhouse

Chicago, Illinois
February 24, 1986

Statement of Income

Twelve Months Ended December 31	1985	1984	1983
			(In Millions)
Revenues			
Forest Products	**$ 204.4**	$ 233.3	$ 241.2
Natural Resources	**609.4**	547.1	534.4
Real Estate	**436.3**	413.5	288.8
Services and Construction	**286.4**	237.9	228.7
Transportation	**4,901.5**	5,230.0	4,724.0
Total revenues	**6,438.0**	6,661.8	6,017.1
Operating Expenses			
Forest Products	**183.9**	212.2	208.0
Natural Resources	**462.8**	419.6	389.2
Real Estate	**94.6**	111.9	71.2
Services and Construction	**269.2**	223.0	209.9
Transportation	**4,639.8**	4,880.4	4,478.2
Total operating expenses	**5,650.3**	5,847.1	5,356.5
Operating Income	**787.7**	814.7	660.6
Other Income—Net	**16.1**	73.0	17.4
Interest Expense	**120.0**	123.3	136.7
Income from Continuing Operations Before Income Taxes	**683.8**	764.4	541.3
Federal Income Tax			
Currently payable	**8.6**	8.3	43.1
Deferred	**174.3**	230.9	148.0
State Income Tax	**31.3**	34.4	16.8
Total income taxes	**214.2**	273.6	207.9
Income from Continuing Operations	**469.6**	490.8	333.4
Discontinued Operations, Net of Income Taxes	—	—	406.5
Net Income	**$ 469.6**	$ 490.8	$ 739.9
Net Income Per Share of Common Stock			
Continuing operations	**$ 2.67**	$ 2.61	$ 1.77
Discontinued operations	$ —	$ —	$ 2.16
Total	**$ 2.67**	$ 2.61	$ 3.93
Average Number of Common and Common Equivalent Shares	**175.6**	188.3	188.4

(See notes to financial statements)

Balance Sheet

Year Ended December 31	1985	1984
		(In Millions)
Assets		
Current Assets		
Cash and temporary investments, at cost which approximates market	$ 535.6	$ 815.2
Accounts receivable, less allowances	880.1	864.9
Inventories	247.1	286.0
Other	86.3	59.5
Total current assets	1,749.1	2,025.6
Other Assets	553.4	556.6
Properties, Plant and Equipment	14,221.8	13,722.8
Less—accumulated depreciation, depletion and amortization	4,716.7	4,656.3
Net properties	9,505.1	9,066.5
Total Assets	$11,807.6	$11,648.7

Liabilities and Stockholders' Equity		
Current Liabilities		
Accounts payable and accrued liabilities	$ 1,224.5	$ 1,228.5
Long term debt due within one year	196.8	148.1
Total current liabilities	1,421.3	1,376.6
Long Term Debt Due After One Year	1,597.6	1,668.0
Other Liabilities	499.9	496.2
Deferred Federal Income Tax	2,472.0	2,286.8
Redeemable Preference Shares of a Subsidiary	52.6	52.6
Stockholders' Equity		
Common stock	190.0	190.1
Paid-in capital	693.1	694.7
Retained income	5,454.4	5,159.8
Unamortized value of restricted stock	(5.8)	(1.2)
Treasury stock, at cost	(567.5)	(274.9)
Total stockholders' equity	5,764.2	5,768.5
Total Liabilities and Stockholders' Equity	$11,807.6	$11,648.7

(See notes to financial statements)

Statement of Changes in Financial Position

Twelve Months Ended December 31	1985	1984	1983
			(In Millions)
Cash Provided By Operations			
Working capital provided by (used for) operations			
Income from continuing operations	**$ 469.6**	$ 490.8	$ 333.4
Items not requiring current use of funds			
Depreciation, depletion and amortization	**569.1**	551.7	526.6
Deferred income taxes	**188.1**	250.8	158.5
Equity in undistributed (earnings) losses of unconsolidated companies	**12.4**	(18.8)	(4.6)
Other—net	**13.7**	103.9	77.0
Total from continuing operations	**1,252.9**	1,378.4	1,090.9
Income from discontinued operations	**—**	—	406.5
Items not requiring current use of funds			
Deferred income taxes	**—**	—	120.4
Other—net	**—**	—	14.3
Total from discontinued operations	**—**	—	541.2
Total from operations	**1,252.9**	1,378.4	1,632.1
Changes in Working Capital			
Accounts receivable	**(15.2)**	255.6	(31.1)
Inventories	**38.9**	(15.7)	24.3
Accounts payable and accrued liabilities	**(4.0)**	(67.4)	125.7
Other current assets/liabilities—net	**21.9**	(30.7)	(7.1)
Total	**41.6**	141.8	111.8
Cash provided by operations	**1,294.5**	1,520.2	1,743.9
Cash Used For Dividends	**(175.1)**	(187.5)	(166.0)
Investment Activities			
Capital expenditures	**(1,078.3)**	(1,111.6)	(958.3)
Property sold or retired	**54.8**	70.8	34.0
Noncurrent assets of discontinued operations—net	**—**	—	472.4
Other—net	**(11.3)**	(164.6)	13.9
Total investment activities	**(1,034.8)**	(1,205.4)	(438.0)
Financing Activities			
Long term debt incurred	**142.4**	213.1	109.0
Reduction in long term debt	**(212.8)**	(154.5)	(365.7)
Debt obligations of discontinued operations	**—**	—	(318.0)
Purchase of treasury stock	**(302.1)**	(275.1)	—
Other—net	**8.3**	2.5	53.2
Total financing activities	**(364.2)**	(214.0)	(521.5)
Increase (Decrease) in Cash and Temporary Investments	**(279.6)**	(86.7)	618.4
Cash and Temporary Investments			
Beginning of the year	**815.2**	901.9	283.5
End of the year	**$ 535.6**	$ 815.2	$ 901.9

(See notes to financial statements)

Statement of Stockholders' Equity

	Common Stock	Treasury Stock	Common Stock	Treasury Stock	Paid-In Capital	Retained Income	Unamortized Value of Restricted Stock
	(Shares in Thousands)		(Dollars in Millions)				
Balance December 31, 1982	187,768	182	$ 187.8	$ (2.4)	$ 670.6	$4,261.7	$ (1.5)
1983 net income						739.9	
Dividends declared						(145.1)	
Conversion of debentures	1,523		1.5		12.0		
Issuance under Growth Plan		(182)		2.4	.9		(3.5)
Exercise of stock options	92		.1		1.0		
Issuance under Employe Stock Purchase and Savings Plan	592		.6		10.5		
Dividend reinvestment and stock purchase plan	91		.1		1.6		
Other	(5)				(.1)		2.7
Balance December 31, 1983	190,061		$ 190.1	$	$ 696.5	$4,856.5	$ (2.3)
1984 net income						490.8	
Dividends declared						(187.5)	
Exercise of stock options	33	(17)		.4	(.1)		
Purchase of treasury stock, at cost		10,978		(275.1)			
Other		10		(.2)	(1.7)		1.1
Balance December 31, 1984	190,094	10,971	$ 190.1	$ (274.9)	$ 694.7	$5,159.8	$ (1.2)
1985 net income						469.6	
Dividends declared						(175.1)	
Issuance under Growth Plan		(281)		7.0	.2		(7.2)
Exercise of stock options		(98)		2.8	(1.8)		
Purchase of treasury stock, at cost		9,753		(302.1)			
Other	(70)	16	(.1)	(.3)		.1	2.6
Balance December 31, 1985	**190,024**	**20,361**	**$ 190.0**	**$ (567.5)**	**$ 693.1**	**$5,454.4**	**$ (5.8)**

Note: SFSP has authorized common stock of 600 million shares with a par value of $1.00. Also authorized are 200 million shares of preferred stock with a par value of $1.00, none of which was outstanding at December 31, 1985.

 (See notes to financial statements)

Notes to Financial Statements

Note 1: Summary of Significant Accounting Policies

Principles of Consolidation
The accompanying consolidated financial statements include the accounts of Santa Fe Southern Pacific Corporation (SFSP) and all entities over 50% owned directly or indirectly, by SFSP on a consolidated basis except for companies engaged in insurance, financial and leasing services. Investments in unconsolidated subsidiaries and affiliates and 20% to 50% owned entities are accounted for under the equity method.

Revenue Recognition
Revenues from advance coal royalties are recognized in income in the year received. The revenues and expenses of petroleum trading activities included in petroleum marketing operations are presented on a net basis whereby only the gross margin from such activities is recorded as revenues. The percentage of completion method is used to account for long term construction contracts.

Properties
Properties are stated at cost and include capitalized interest cost incurred during construction applicable to continuing operations of $42.9 million in 1985, $42.0 million in 1984 and $37.7 million in 1983.

Additions and replacements are capitalized. Expenditures for maintenance and repairs are charged to income. Upon sale or retirement of units of depreciable railroad and pipeline properties, cost less salvage is charged to accumulated depreciation and no gain or loss is recognized. With respect to all other property units sold or retired, gain or loss is recognized. Property depreciation is based on the estimated service lives of the related assets.

Leasehold Interests and Exploratory Costs
SFSP follows the successful efforts method of accounting for petroleum properties. All costs incurred in acquiring petroleum leasehold interests, consisting primarily of bonus payments, are capitalized. When a lease is proved to be productive, its entire cost is transferred to productive petroleum properties. If a lease proves to be non-productive, the entire cost of the lease is charged against the reserve for unproved leasehold interests. This reserve is provided by amortizing the cost of unproved leasehold interests based on past experience, and adjusted as considered necessary. Geological and geophysical costs, exploratory dry hole costs and annual delay rentals on unexplored leases are charged to income.

Depreciation and Depletion of Productive Petroleum Properties
Productive petroleum properties, consisting principally of tangible and intangible costs incurred in developing a property and costs of productive leasehold interests, are depreciated or depleted on a unit of production method based on annual estimates of remaining proved developed reserves or proved reserves, as appropriate, for each field. Certain other petroleum properties are depreciated on a straight-line basis. Based on continuing evaluations of various factors, impairments (additional depreciation and depletion) are recorded to the extent that the net book value of costs, on a field basis, exceeds the estimated undiscounted future net revenues of proved oil and gas reserves, based on current prices. These impairments aggregated $19.7 million, $36.5 million and $25.6 million in 1985, 1984 and 1983, respectively.

Inventories
Material and supply inventories, which represent approximately 90% of all inventories, are valued at the lower of cost (average or first-in, first-out) or market. Inventories entering into the determination of cost of goods sold of the forest products and petroleum marketing operations are valued using the last-in, first-out method.

Federal Income Tax
Provisions for federal income tax recognize the tax effects of all transactions entering into the determination of income for financial reporting purposes irrespective of when such transactions are reported for federal income tax purposes. Deferred income taxes are provided to recognize differences in the timing of income and expense for income tax and financial reporting purposes. Investment tax credits are treated as reductions of income tax expense using the flow-through method.

Notes to Financial Statements

Note 2: Business Combination

On December 23, 1983 Santa Fe Industries, Inc. (Santa Fe) and Southern Pacific Company (Southern Pacific) became wholly owned subsidiaries of SFSP. The business combination was accounted for as a pooling of interests and the results of operations of prior periods are reported on a combined basis.

The prior approval of the Interstate Commerce Commission (ICC) is required to combine the railroad and trucking operations of Santa Fe and Southern Pacific under the control of SFSP. To permit consummation of the combination of Santa Fe and Southern Pacific pending receipt of ICC approval, the common stock of the Southern Pacific Transportation Company (SPT) has been deposited in an independent voting trust. The terms of the voting trust provide that SFSP, Santa Fe and Southern Pacific will not control SPT until ICC approval is obtained. While there is no assurance of ICC approval, because of the ICC's recent approval of other major rail combinations, management is confident that ICC approval will be obtained; accordingly, the financial statements include all assets and operations of SPT. Should the ICC not approve the combination of the railroad and trucking operations, SFSP may be required to dispose of all or part of the trusteed operations or SFSP's other railroad operations. At this time SFSP is unable to identify the assets and operations, if any, which may be required to be disposed of, and the financial statements do not include any adjustments which might be necessary should the ICC require such a disposal. Summary financial information of SPT follows:

Year ended December 31,	**1985**	1984	1983
			(In Millions)
Operating revenues	**$2,545.8**	$2,713.5	$2,430.3
Operating expenses	**2,529.6**	2,658.0	2,432.2
Income (loss) from operations	**16.2**	55.5	(1.9)
Other income	**162.3**	149.9	109.8
Interest expense	**74.3**	81.5	81.4
Income taxes (benefit)	**(13.9)**	(17.5)	(5.8)
Net income	**$ 118.1**	$ 141.4	$ 32.3

December 31,	**1985**	1984
		(In Millions)
Current assets	**$ 611.8**	$ 563.5
Other assets	**4,180.6**	4,115.0
Total assets	**$4,792.4**	$4,678.5
Current liabilities	**$ 718.0**	$ 653.5
Long term debt	**777.1**	841.1
Deferred income taxes	**717.7**	715.8
Other long term liabilities	**264.7**	271.3
Redeemable preference shares of a subsidiary	**52.6**	52.6
Stockholder's equity	**2,262.3**	2,144.2
Total liabilities and stockholder's equity	**$4,792.4**	$4,678.5

Other income of SPT has been reclassified in SFSP's financial statements by business segment.

During 1983, both The Atchison, Topeka and Santa Fe Railway Company (Santa Fe Railway) and the SPT adopted depreciation accounting for track structure; however certain differences exist between the methodologies used. As a result of the requirement to maintain the SPT as an independent entity pending ICC approval, it is anticipated that the depreciation accounting methods and certain other differences in accounting policies will not be conformed until the merger of the rail systems is approved. The impact of conforming such policies, while not presently determinable, may result in significant charges. It is also anticipated that, when the rail systems are merged, certain substantial nonrecurring costs related to labor force reductions and resulting labor protection, and excess equipment and facilties will be recorded. These nonrecurring costs will result from actions to be taken that are expected to result in lower rail operating costs in the future.

Note 3: Discontinued Operations

On June 15, 1983, Southern Pacific completed the sale of the stock of its two wholly-owned communications subsidiaries, Southern Pacific Communications Company (SPCC) and Southern Pacific Satellite Company (SPSC), to GTE Corporation (GTE) for cash pursuant to a Stock Purchase Agreement executed in October 1982. The sales price was $740.5 million ($700.0 million for SPCC and $40.5 million for SPSC) less an adjustment of $13.1 million for prepayment penalties and interest differentials on refinancing of certain debt of SPCC.

As of December 31, 1985, Southern Pacific was contingently liable as guarantor for debt and other obligations of SPCC and SPSC aggregating $82.1 million. GTE has agreed to indemnify Southern Pacific against any and all claims, obligations and liabilities arising out of or based upon any of such guarantees.

The communication companies had revenues of $297.4 million in the five and one-half months ended June 15, 1983.

On September 30, 1983, Southern Pacific reached agreement on the terms for the sale of Ticor and its subsidiaries (other than Constellation Reinsurance Company) for $271.3 million, payable $240.0 million in cash at closing and a $31.3 million, 13½%, subordinated note. The sale was closed on February 1, 1984 with no gain or loss. Ticor, which had been accounted for on the equity method, had income before income taxes of $14.3 million in 1983.

Income from discontinued operations is as follows:

	1983
	(In Millions)
Income from discontinued operations before income taxes	$117.4
Income taxes	40.3
Income from operations	77.1
Gain on sale before income taxes	487.7
Income taxes	158.3
Gain on sale	329.4
Income from discontinued operations	$406.5

The effective rate of income tax applicable to discontinued operations reflects the substantial portion of such income which is taxed at capital gains rates.

Notes to Financial Statements

Note 4: Investments

Included in other assets is an investment in Bankers Leasing and Financial Corporation (Bankers) which is a wholly-owned unconsolidated subsidiary. Its income before income taxes is included in revenues of the Services and Construction business group. Consolidated financial information of Bankers and its subsidiaries is summarized as follows:

Year Ended December 31,	1985	1984	1983
			(In Millions)
Results of Operations			
Revenues	**$121.5**	$111.2	$ 78.4
Expenses	**102.8**	94.0	63.7
Income before income taxes	**$ 18.7**	$ 17.2	$ 14.7

December 31,	1985	1984
		(In Millions)
Financial Position		
Net investment in leases	**$612.0**	$555.2
Cash and other assets	**16.9**	18.6
Total assets	**$628.9**	$573.8
Equipment loans payable (secured by equipment under lease)	**$ 73.4**	$211.7
Other liabilities	**471.0**	290.2
Stockholder's equity	**84.5**	71.9
Total liabilities and stockholder's equity	**$628.9**	$573.8

Bankers leases equipment to certain consolidated subsidiaries of SFSP. The net investment in such leases applicable to continuing operations was $53.3 million at December 31, 1985 and $50.9 million at December 31, 1984. Revenues from these leases were $15.1 million for 1985; $13.6 million for 1984; and $12.9 million for 1983.

SFSP's equity in earnings from real estate joint ventures is included in revenues of the real estate group. Amounts included in real estate revenues are $6.2 million in 1985, $17.8 million in 1984 and $20.1 million in 1983.

Note 5: Federal Income Tax

The provision for federal income tax applicable to continuing operations is computed as follows:

	1985	1984	1983
			(In Millions)
Income before federal income tax	**$652.5**	$730.0	$524.5
Statutory tax rate	**46%**	46%	46%
Tax at statutory rate	**300.2**	335.8	241.3
Less reductions for:			
Investment tax credit	**67.1**	68.2	46.4
Capital gains	**47.7**	36.5	28.4
Other	**2.5**	(8.1)	(24.6)
Total	**117.3**	96.6	50.2
Total federal income tax	**$182.9**	$239.2	$191.1
Effective tax rate	**28.0%**	32.8%	36.4%
Effect of reductions on net income per share	**$ .67**	$ .51	$ .27

The provision for deferred federal income tax applicable to continuing operations is comprised of the following tax effects of timing differences:

	1985	1984	1983
			(In Millions)
Additional depreciation for tax purposes	**$210.0**	$190.4	$160.4
Investment tax credits earned over amounts realized	**(27.2)**	(32.5)	(2.9)
Reclassification related to sale of a subsidiary	**—**	31.7	—
Deferred capital gain income	**27.3**	13.3	—
Increase in accruals not deducted for tax purposes until paid, due to a change in the tax law	**(27.5)**	—	—
Other	**(8.3)**	28.0	(9.5)
Total deferred federal income tax	**$174.3**	$230.9	$148.0

At December 31, 1985, SFSP had approximately $53 million of investment tax credit carry forward available for federal income tax purposes (none for financial reporting purposes).

The federal income tax returns of Santa Fe and Southern Pacific have been examined through 1980. All years prior to 1969 are closed to further administrative assessment of tax. Although refunds have been received for the years 1954-1961, final approval of the refunds received for 1954-1958 is pending before the Joint Committee on Taxation. Issues relating to the years 1962-1980 are being contested through various stages of administrative appeal or litigation. Management believes adequate provision has been made for any adjustment which might be assessed for years through 1985.

Notes to Financial Statements

Note 6: Long Term Debt

Long term debt at December 31, 1985 and 1984 consists of the following:

	1985	1984
		(In Millions)
Equipment obligations, 5.75% to 15.25%, maturing from 1986 to 1996	**$1,056.1**	$1,093.6
Mortgage bonds, 2.75% to 8.2%, maturing from 1986 to 2001	**312.3**	319.5
Debentures, 8.35% to 10.35%, maturing from 1988 to 2002	**167.4**	172.5
Other obligations, 3.75% to 13%, maturing from 1986 to 1998	**208.6**	177.0
Capitalized leases	**50.0**	53.5
Total long term debt	**1,794.4**	1,816.1
Due within one year	**196.8**	148.1
Due after one year	**$1,597.6**	$1,668.0

Projected principal repayments of long term debt during the five years 1986 through 1990 (excluding capitalized leases) are $187.6 million, $155.1 million, $156.0 million, $207.6 million, and $197.1 million, respectively.

Substantially all railroad property is subject to liens securing mortgage bonds or equipment obligations. In addition, certain debt agreements of subsidiary companies include covenants which place limitations on the amount of indebtedness that may be incurred and dividends which may be paid by the related subsidiary companies.

As of December 31, 1985, SFSP and its consolidated subsidiaries had unused bank lines of credit aggregating $310.0 million. The Company pays a fee of 1/8 percent on $230.0 million and 1/4 percent on $80.0 million of the unused bank lines of credit.

Note 7: Leases

SFSP leases certain locomotives, freight cars, trailers, data processing equipment and other property. Future minimum lease payments for capital and operating leases as of December 31, 1985 are summarized as follows:

	Capital Leases	Operating Leases
		(In Millions)
1986	$ 12.3	$100.1
1987	11.4	87.1
1988	9.4	73.7
1989	8.5	58.3
1990	6.2	50.2
Later years	24.6	142.2
Total minimum payments	$ 72.4	$511.6
Less amount representing interest	22.4	
Present value of minimum lease payments	50.0	
Less current portion	9.2	
Long term portion	$ 40.8	

Leased assets under capital leases presented in the accompanying balance sheet totaled $86.3 million at December 31, 1985, with related accumulated amortization of $51.8 million, and $84.6 million at December 31, 1984, with related accumulated amortization of $49.8 million.

Rental expense for operating leases applicable to continuing operations was $144.7 million in 1985, $120.1 million in 1984, and $104.5 million in 1983. Contingent rentals and sublease rentals were not significant.

Notes to Financial Statements

Note 8: Stock Option and Growth Plans

Under various plans, options have been granted to key employes to purchase common stock of SFSP at a price not less than the fair market value at the date of grant. On April 26, 1983, Santa Fe stockholders approved the Santa Fe 1983 Incentive Stock Option Plan under which options are available for grant until November 30, 1992 covering a maximum of 4,812,000 SFSP shares. This plan was subsequently amended to provide for participation of employes of Southern Pacific and its subsidiaries, and its name was changed to the Santa Fe Southern Pacific 1983 Incentive Stock Option Plan.

Activity in all Plans during 1985 and 1984 is summarized below:

	SFSP Shares	Average Price
Options outstanding at December 31, 1983	1,538,758	$19.94
Granted	1,017,100	25.50
Exercised	99,225	12.35
Surrendered or terminated	113,512	16.87
Options outstanding at December 31, 1984	2,343,121	$22.83
Exercised	178,600	14.50
Surrendered or terminated	125,728	21.96
Options outstanding at December 31, 1985	**2,038,793**	**$23.61**

During 1983, 187,608 shares of SFSP common stock having a fair market value of $3.5 million were awarded under provisions of Santa Fe's Long Term Earnings Growth and Stock Ownership Plan. During 1985, 280,600 shares of common stock having a fair market value of $7.2 million were awarded under provisions of SFSP's Long Term Earnings Growth and Stock Ownership Plan (Growth Plan). Such shares are held by SFSP for future distribution to certain officers and key employes in accordance with the restrictive provisions of the Growth Plan.

Note 9: Stockholder Rights Plan

On January 28, 1986, SFSP declared a dividend of one preferred stock purchase right for each common share outstanding as of February 13, 1986. Under certain conditions, each right may be exercised to buy one one-hundredth of a newly issued share of Series A Junior Participating Preferred Stock at a price of $125. The rights may only be exercised after a person or group acquires ownership of 20% or more of SFSP's common shares or commences a tender or exchange offer which upon consummation would result in ownership of 30% or more of the common shares. The rights, which do not have voting rights, expire on February 28, 1996 and may be redeemed by SFSP at a price of $.05 per right at any time until 15 days, subject to extension, after a public announcement of the acquisition of 20% of SFSP's common stock.

If 50% of SFSP's common stock is acquired by any person or if certain other events occur, then generally, each right not owned by a 20%-or-more stockholder will entitle the holder to purchase, at the right's then-current exercise price, shares of SFSP common stock having a value of twice the right's exercise price. In addition, if SFSP is involved in a merger or other business combination transaction with another person in which its common shares are changed or converted, or sells 50% or more of its assets or earning power, each right (except those held by a 20%-or-more stockholder) will entitle its holder to purchase shares of common stock of the surviving corporation having a value of twice the rights' exercise price.

Note 10: Redeemable Preference Shares of a Subsidiary

The St. Louis Southwestern Railway Company (SSW), 99.8 percent owned by a wholly-owned subsidiary of Southern Pacific, has entered into two agreements providing for the purchase by the Federal Railroad Administration of up to $53.5 million ($48.5 million Series A and $5.0 million Series B) of SSW's non-voting redeemable preference shares.

The Series A shares are subject to mandatory redemption over a 20-year period commencing in 1991, at which time dividends at an annual rate of 4.2% shall be declared and paid over the same period. The agreement also provides for acceleration of redemption payments or conversion into fixed interest debt obligations, under certain events of default.

The Series B shares are subject to mandatory redemption over a 15-year period commencing on the fifth anniversary date of issuance. Dividends at an annual rate of 15.1% shall be declared and paid over a 10-year period commencing on the tenth anniversary date of issuance.

The agreements contain certain restrictions on dividend payments by SSW to its common and preferred shareholders. Dividend payments are restricted to increases in net stockholders' equity, as defined in the agreements. At December 31, 1985, $48.3 million of Series A and $4.3 million of Series B redeemable preference shares were outstanding.

Notes to Financial Statements

Note 11: Pension and Employe Benefit Plans

SFSP and its subsidiaries have a number of pension plans, the most significant of which is the trusteed non-contributory Santa Fe Southern Pacific Retirement Plan (the Plan) which fully complies with ERISA requirements. The Plan was formed by combining the Santa Fe Retirement Plan and the Southern Pacific Retirement Plan effective January 1, 1985, and covers substantially all officers and employes of SFSP and its subsidiaries not covered by collective bargaining agreements. Total pension expense applicable to continuing operations for 1985, 1984 and 1983 was $24.5 million, $23.0 million and $27.1 million, respectively, which includes amortization of past service cost over 30 years. SFSP has made annual contributions to the Plan approximately equal to pension expense. Accumulated plan benefits and plan assets of the Plan as of the latest valuation date (January 1, 1985) and the prior valuation dates (January 1 and September 30, 1984) are as follows:

	1985	1984
		(In Millions)
Actuarial present value of accumulated plan benefits		
Vested	$461.5	$418.6
Non-Vested	7.7	17.1
Total	$469.2	$435.7
Net assets available for plan benefits	$591.8	$566.1

Assumed rates of return used in determining the actuarial present value of accumulated plan benefits varied for different groups of participants from 9% to 12% in 1985, and 7% to 12% in 1984.

In addition to providing pension benefits, SFSP and its subsidiaries provide health care and life insurance benefits for certain retired employes. The costs of these benefits are recognized as expenses primarily when claims are paid; however actuarially determined accruals are used for some life insurance benefits. Amounts expensed for these plans applicable to continuing operations were $27.7 million in 1985, $15.7 million in 1984 and $13.2 million in 1983.

Note 12: Other Income—Net

Other income-net consists of the following:

	1985	1984	1983
			(In Millions)
Interest and dividend income	$ 80.3	$128.4	$65.5
Reinsurance operations	(25.3)	(5.0)	
Gain on sale of marketable equity security	13.5	—	
Sale of federal income tax benefits	—	—	12.0
Discontinuance of certain trucking operations	(1.2)	(2.7)	(17.0)
Unallocated corporate expenses	(39.0)	(34.4)	(45.3)
Expenses incurred in connection with the business combination	(7.5)	(4.1)	(18.4)
Other-net	(4.7)	(9.2)	20.6
Total	$ 16.1	$ 73.0	$17.4

Note 13: Contingencies

SFSP's rail subsidiaries are participants in a service interruption policy. The maximum contingent premiums are $114.3 million, which may result from work stoppages on other railroads.

In December 1981, Texas Utilities Company and its subsidiary, Chaco Energy Company, brought an action against Santa Fe and others alleging violations of law in connection with a long term coal lease agreement between Chaco and one of Santa Fe's subsidiaries. The complaint alleges that Santa Fe and others fixed the price of coal in the San Juan Basin area of New Mexico, restricted competition in the production and sale of coal from this area, and fraudulently induced Chaco to enter the coal lease agreement. The complaint seeks damages in an unspecified amount and to have the coal lease agreement declared void and unenforceable. Santa Fe has denied the allegations and raised certain additional defenses. The case is in discovery.

On October 6, 1982, the Navajo Tribe of Indians filed a lawsuit in federal court against Santa Fe Mining, Inc. and others, as representatives of a class of defendants, seeking a declaration that an addition of approximately two million acres to the Navajo Reservation in Northwest New Mexico, authorized by a 1907 Executive Order, still exists. The territory includes the coal fields in the South Hospah, Star Lake and Gallo Wash areas. The Tribe claims they are entitled to title, immediate possession of the land and trespass damages against all the defendants. On January 23, 1984 the federal district court dismissed the complaint for lack of jurisdiction to hear the claim. The matter is presently on appeal before the 10th Circuit Court of Appeals.

In October 1984, a civil action was filed in federal court alleging that certain railroads had conspired in violation of the antitrust laws, to frustrate the construction of a coal slurry pipeline. The complaint asserts damages in the amount of $940 million, prior to trebling. Santa Fe was not originally named in the lawsuit and the court only recently granted plaintiff's motion to amend the complaint to add Santa Fe as a defendant. Santa Fe has now filed pleadings denying all the material allegations against it and participating in the discovery.

SFSP is a party to a number of other legal actions arising in the ordinary course of business. In the opinion of SFSP management, none of these actions nor the foregoing cases will have a material adverse effect on the consolidated financial position of SFSP.

Notes to Financial Statements

Note 14: Accounts Payable and Accrued Liabilities

Accounts payable and accrued liabilities at December 31, 1985 and 1984 consist of the following:

	1985	1984
	(In Millions)	
Drafts payable	**$ 29.2**	$ 31.9
Accounts and wages payable	**356.7**	409.4
Claim reserves	**141.2**	127.1
Vacations	**145.9**	149.6
Interest	**41.9**	43.2
Federal income tax	**7.1**	5.0
Taxes, other than federal income tax	**132.9**	115.6
Other	**369.6**	346.7
Total	**$1,224.5**	$1,228.5

Note 15: Petroleum Producing Operations

Information relating to oil and gas producing activities is presented in the following schedules. Historical information about proved oil and gas reserve quantities, capitalized costs, costs incurred in and results of operations for petroleum producing activities is presented. The standardized measure of discounted future net cash flows and changes therein are also presented. Certain reserve quantities as well as certain information regarding future production and discounted cash flows were determined by Riggs and Associates, Inc., an independent petroleum consultant.

Reserve Quantities (Unaudited)
Presented below are the net proved crude oil and natural gas reserves (all located in the United States) of SFSP's petroleum producing operations and a summary of changes in the quantities of proved reserves during the periods indicated. Reserve quantities cannot be measured exactly. Estimates of reserves require extensive judgments of reservoir engineering data and are generally less precise than other estimates made in connection with financial disclosures. Reserve estimates are reviewed periodically to reflect new geological and geophysical data and changing technological and economic conditions and are subject to revision as additional data becomes available during the producing life of a reservoir.

	1985	1984	1983	1985	1984	1983
	Crude Oil (Million Barrels)			Natural Gas (Billion Cubic Feet)		
Proved reserves:						
Beginning of year	**135.0**	138.1	138.3	**192.2**	189.3	188.7
Changes during the year						
Revisions of previous estimates	**(.1)**	1.5	.5	**6.3**	1.8	(9.2)
Improved recovery	**4.1**	4.4	6.6	**5.7**	.5	.3
Purchase of minerals in place	**—**	.1	2.2	**.1**	.9	.8
Extensions, discoveries and other additions	**10.5**	8.6	8.0	**28.5**	28.0	35.4
Production	**(18.2)**	(17.7)	(17.5)	**(31.8)**	(28.3)	(26.7)
End of year	**131.3**	135.0	138.1	**201.0**	192.2	189.3
Proved developed reserves at end of year	**121.5**	123.1	126.0	**193.2**	184.5	181.7

Proved developed reserves at January 1, 1983 were 126.8 million barrels of crude oil and 186.8 billion cubic feet of natural gas.

Capitalized Costs
The following schedule presents total capitalized costs of proved and unproved properties and accumulated depreciation, depletion and amortization related to petroleum producing operations:

As of December 31,	1985	1984
	(In Millions)	
Unproved oil and gas properties	**$ 286.3**	$ 267.0
Proved oil and gas properties	**1,163.6**	1,047.0
Total capitalized costs	**1,449.9**	1,314.0
Accumulated depreciation, depletion and amortization	**(642.4)**	(559.5)
Net capitalized costs	**$ 807.5**	$ 754.5

Costs Incurred
Presented below are costs incurred in petroleum acquisition, exploration and development activities:

For the year	1985	1984	1983
	(In Millions)		
Acquisition of properties			
Proved	**$ 2.9**	$ 2.2	$ 19.9
Unproved	**44.4**	38.3	54.8
Exploration costs	**57.6**	62.6	47.3
Development costs	**127.0**	135.8	89.7
Total	**$231.9**	$238.9	$211.7

The above information includes all costs incurred in each activity, whether capitalized or charged to expense at the time they were incurred.

Results of Operations for Petroleum Producing Activities

The results of operations for petroleum producing activities, excluding corporate overhead and interest costs, were as follows:

For the year	1985	1984	1983
			(In Millions)
Revenues	**$506.4**	$501.6	$495.3
Production costs	**170.1**	176.1	171.3
Exploration expenses (excluding amortization of unproved leasehold interests)	**42.9**	42.6	44.7
Depreciation, depletion and amortization	**148.4**	149.1	131.5
Results before income taxes	**145.0**	133.8	147.8
Income tax expense	**60.5**	58.7	64.7
Results of operations for petroleum producing activities (excluding corporate overhead and interests costs)	**$ 84.5**	$ 75.1	$ 83.1

Standardized Measure of Discounted Future Net Cash Flows (Unaudited)

Future cash inflows were determined on a property-by-property basis by applying estimated year end prices to the estimated future production of proved reserves. The weighted average prices used for year end 1985 were $21.80 per barrel of oil and $2.48 per thousand cubic feet of gas. Future production costs (including Windfall Profit Tax) were also determined on a property-by-property basis based on estimated year end costs. Future development costs relating to proved undeveloped reserves were based on costs in effect at December 31, 1985. Future income tax expenses were computed by applying year end statutory tax rates to the future pretax net cash flows less the tax basis of the proved properties involved. Future income tax expenses also give effect to permanent differences and tax credits and allowances relating to SFSP's proved oil and gas reserves.

The data should not be construed to represent a forecast of future net cash flows or the current value of proved crude oil and natural gas reserves. Actual future revenues from the production of proved reserves may vary significantly from the estimated future cash inflows due to changes in crude oil prices (which have generally declined since December, 1985) and gas prices, and production of the reserves may not occur in the periods assumed. Actual production and development costs will also vary from those estimated due to inflation and other factors. This information is presented primarily as a tool to allow for reasonable comparison of oil and gas reserves through the use of a standardized measurement method. Therefore the data should not be used for other than its intended purpose.

Presented below are future cash flows from estimated production of proved crude oil and natural gas reserves, discounted at 10% as required by Financial Accounting Standards Board Statement No. 69.

For the year ended December 31,	1985	1984	1983
			(In Millions)
Future cash inflows	**$3,362.9**	$3,644.8	$3,724.9
Future production costs	**1,458.3**	1,494.8	1,524.1
Future development costs	**21.1**	46.3	47.6
Future income tax expense	**749.8**	852.9	872.4
Future net cash flows	**1,133.7**	1,250.8	1,280.8
10% annual discount for estimated timing of cash flows	**408.9**	475.3	486.7
Standardized measure of discounted future net cash flows	**$ 724.8**	$ 775.5	$ 794.1

The following table summarizes the principal sources of change in the standardized measure of discounted future net cash flows:

	1985	1984	1983
			(In Millions)
Beginning of year	**$775.5**	$794.1	$804.7
Sales of oil and gas produced, net of production costs	**(336.3)**	(325.5)	(324.0)
Net changes in prices and production costs	**(141.0)**	14.5	(56.8)
Changes in estimated future development costs	**(21.4)**	(72.6)	(34.7)
Extensions, discoveries, and improved recovery, less related cost	**179.2**	133.1	174.1
Previously estimated development costs incurred during the period	**46.6**	73.8	33.4
Revisions of previous quantity estimates	**(4.7)**	21.4	(4.9)
Purchase of reserves in place	**.3**	4.1	2.2
Accretion of discount	**130.0**	133.4	137.9
Net change in income taxes	**50.4**	12.0	25.9
Other	**46.2**	(12.8)	36.3
End of year	**$724.8**	$775.5	$794.1

Notes to Financial Statements

Note 16: Summarized Quarterly Operating Results (Unaudited)

	1985				1984			
	First	**Second**	**Third**	**Fourth**	First	Second	Third	Fourth
								(In Millions)
Revenues	**$1,564.0**	**$1,633.7**	**$1,654.6**	**$1,585.7**	$1,644.9	$1,697.4	$1,665.8	$1,653.7
Operating income	**$ 111.2**	**$ 199.5**	**$ 261.5**	**$ 215.5**	$ 173.6	$ 225.9	$ 224.0	$ 191.2
Net income	**$ 61.6**	**$ 119.3**	**$ 151.4**	**$ 137.3**	$ 107.0	$ 143.0	$ 137.4	$ 103.4
Net income per share	**$ .34**	**$ .67**	**$ .87**	**$ .79**	$ .56	$ .75	$ .73	$ .57

Notes to Financial Statements

Note 17: Information on Business Segments

Revenues and operating income for each business segment are shown on page 28. Intersegment sales are not significant and no one customer accounts for 10% or more of consolidated revenues.

Identifiable assets and properties, plant and equipment at December 31, 1985, 1984 and 1983 and capital expenditures and depreciation, depletion and amortization expenses for the three years then ended are as follows:

	1985	1984	1983
			(In Millions)
Identifiable assets			
Forest Products	$ 175.9	$ 186.6	$ 191.3
Natural Resources	1,081.7	1,065.7	979.8
Real Estate	614.0	551.6	528.5
Services and Construction	56.4	67.3	47.5
Transportation	9,022.9	8,646.3	8,180.9
Corporate	676.5	941.5	1,317.9
Total	11,627.4	11,459.0	11,245.9
Investment in unconsolidated subsidiaries and other affiliated companies			
Bankers Leasing and Financial	110.8	103.6	70.8
Other	69.4	86.1	71.1
Total	180.2	189.7	141.9
Total assets	$11,807.6	$11,648.7	$11,387.8
Properties, plant and equipment			
Forest Products	$ 239.9	$ 234.2	$ 221.0
Natural Resources	1,560.3	1,429.3	1,232.7
Real Estate	602.5	552.6	525.8
Services and Construction	14.6	14.5	19.3
Transportation	11,782.9	11,473.6	11,236.2
Corporate	21.6	18.6	17.3
Total	$14,221.8	$13,722.8	$13,252.3
Capital expenditures			
Forest Products	$ 11.3	$ 17.6	$ 12.7
Natural Resources	201.9	252.6	223.8
Real Estate	84.4	74.7	62.1
Services and Construction	1.1	4.5	1.0
Transportation	779.0	754.8	508.5
Corporate	.6	7.4	4.2
Continuing operations	1,078.3	1,111.6	812.3
Discontinued operations	—	—	146.0
Total	$ 1,078.3	$ 1,111.6	$ 958.3

	1985	1984	1983
			(In Millions)
Depreciation, depletion and amortization expense			
Forest Products	$ 9.0	$ 10.8	$ 10.2
Natural Resources	154.5	140.3	128.3
Real Estate	5.2	4.7	3.6
Services and Construction	1.4	1.1	1.2
Transportation	396.8	393.0	382.0
Corporate	2.2	1.8	1.3
Continuing operations	569.1	551.7	526.6
Discontinued operations	—	—	15.4
Total	$ 569.1	$ 551.7	$ 542.0
Amortization of capital leases included above	$ 6.9	$ 8.6	$ 8.9

Note 18: Supplementary Information on Changing Prices (Unaudited)

The following supplementary Current Cost information is presented as an alternative to historical cost accounting in accordance with the provisions of the Financial Accounting Standards Board Statements on Financial Reporting and Changing Prices. These statements were issued in response to the belief that financial statements prepared in accordance with generally accepted accounting principles based on historical cost measurements fail to reflect the effects of inflation which results in an overstatement of profits.

The Current Cost method measures the effects of changes in specific prices of property and equipment from the date of acquisition to the present. Amounts were determined through application of specific or internally generated indices to historical costs, vendor quotes, appraisals and other methods as deemed appropriate.

Notes to Financial Statements

Comparison of selected financial data adjusted for effect of changing prices.

	1985	1984	1983	1982	1981
			(In millions of average 1985 dollars)		
Revenues					
As reported	**$ 6,438.0**	$ 6,661.8	$ 6,017.1	$ 5,986.3	$ 6,496.7
Adjusted for inflation	**6,438.0**	6,899.5	6,497.0	6,671.7	7,684.4
Income (loss) from continuing operations (a)					
As reported	**$ 469.6**	$ 490.8	$ 333.4	$ 307.9	$ 491.8
Current cost	**(75.8)**	(104.1)	(345.4)	(385.9)	(159.6)
Income (loss) per share from continuing operations (a)					
As reported	**$ 2.67**	$ 2.61	$ 1.77	$ 1.62	$ 2.58
Current cost	**(.43)**	(.55)	(1.83)	(2.03)	(.84)
Dividends declared per share					
SFSP	**$ 1.00**	$ 1.00			
Santa Fe			$ .75	$ 1.00	$ 1.00
Southern Pacific			1.45	1.30	1.30
Purchasing power gain from net monetary liabilities (b)	**$ 139.4**	$ 134.3	$ 153.0	$ 182.5	$ 411.1
Unrecognized gains (losses) on properties held during the year due to:					
Increases in the general price level	**$ 881.5**	$ 978.2	$ 982.8	$ 1,032.3	$ 2,341.4
Increases in specific prices greater (less) than increases in general price level	**(841.7)**	(272.1)	(167.5)	(323.2)	284.3
Total unrecognized gain	**$ 39.8**	$ 706.1	$ 815.3	$ 709.1	$ 2,625.7
Net assets at December 31 (c)					
As reported	**$ 5,764.2**	$ 5,768.5	$ 5,740.8	$ 5,116.2	$ 4,989.0
Current cost	**19,519.1**	21,614.9	22,499.7	22,763.5	23,912.4
Market price of common share at December 31					
As reported	**$ 34.88**	$ 25.75	$ 26.25		
Adjusted for inflation	**34.33**	26.30	27.90		
Average consumer price index	**322.2**	311.1	298.4	289.1	272.4

At December 31, 1985, the current cost of properties was $24.5 billion, net of accumulated depreciation.

(a) The difference between net income, as reported, and net income for current cost represents the increase in depreciation, depletion and amortization expense which would arise when such expenses are based on assets restated to a current cost basis. Since such increase in depreciation expense is not an allowable deduction for federal income tax purposes, no adjustment has been made to the provision for federal income tax as reported.

Inventories, consisting primarily of operating supplies and replacement materials, are stated at recent purchase prices and have not been adjusted.

(b) The purchasing power gain results from an excess of monetary liabilities over monetary assets. Monetary assets are cash and claims to cash and monetary liabilities are liabilities fixed in terms of dollars and deferred federal income tax. In periods of inflation, monetary assets lose purchasing power because such assets will buy less goods and services than previously. Conversely, monetary liabilities gain purchasing power since dollars with reduced purchasing power will be used to extinguish such liabilities.

(c) The difference between net assets as reported and net assets on a current cost basis represents the increase in properties and leased properties under capital leases resulting from restatement of such properties and accumulated depreciation, depletion and amortization on a current cost basis.

Coal Reserves

In addition to the disclosures above, Statement No. 39 requires disclosure of coal reserves as follows:

	1985	1984	1983	1982	1981
Proved and probable coal reserves (million tons)					
Leased to others	**517**	506	508	509	511
Unleased	**274**	277	273	265	265
Total	**791**	783	781	774	776
Average price received (per ton)					
Royalty	**$ 3.87**	$ 3.90	$ 4.22	$ 3.04	$ 2.78
Production	**$27.91**	$24.73	—	—	—
Tons produced (in thousands)	**2,159**	241	—	—	—

Directors

Joseph F. Alibrandi⋆
Chairman and Chief Executive Officer
Whittaker Corporation
(a diversified manufacturer
and distributor)
Los Angeles, California

Benjamin F. Biaggini•○◆
Retired Chairman and
Chief Executive Officer
Southern Pacific Company
San Francisco, California

Lawrence Cena•
President and Chief Executive Officer
The Atchison, Topeka and
Santa Fe Railway Company
Chicago, Illinois

Richard J. Flamson III▪
Chairman and Chief Executive Officer
Security Pacific Corporation and
Chairman
Security Pacific National Bank
Los Angeles, California

Alan C. Furth•
Vice Chairman
Santa Fe Southern Pacific
Corporation and
President
Southern Pacific Company
San Francisco, California

Robert E. Gilmore⋆▪
Retired President and
Chief Operating Officer
Caterpillar Tractor Co.
(manufacturer of earthmoving,
construction and materials handling
machinery and equipment)
Peoria, Illinois

Robert D. Krebs•
President and
Chief Operating Officer
Santa Fe Southern Pacific Corporation
Chicago, Illinois

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Chairman of the Executive Committee
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(mining, ocean shipping and
land development)
San Francisco, California

Arjay Miller⋆○
Director of various corporations;
Dean Emeritus, Graduate School of
Business, Stanford University
Woodside, California

Michael A. Morphy○▪
President
MorMarketing, Inc.
(marketing of employe benefit concepts)
Pasadena, California

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Director of various corporations;
Retired Chairman of the Board
Cyprus Mines Corporation
(mining and ore processing)
Los Angeles, California

George B. Munroe◆
Chairman and Chief Executive Officer
Phelps Dodge Corporation
(producer of copper and other metals
and manufacturer of copper products)
New York, New York

Jack S. Parker◆▪
Rancher, Retired Vice Chairman,
Director and Executive Officer
General Electric Company
Fairfield, Connecticut

Ellmore C. Patterson•◆
Retired Chairman of the Board
Morgan Guaranty Trust Company
of New York
New York, New York

John S. Reed•○◆
Retired Chairman and
Chief Executive Officer
Santa Fe Industries, Inc. and
Retired Chairman
The Atchison, Topeka and Santa Fe
Railway Company
Chicago, Illinois

John S. Runnells II◆▪
Owner and Operator
Runnells-Pierce Ranch
Bay City, Texas

John J. Schmidt•◆▪
Chairman and Chief Executive Officer
Santa Fe Southern Pacific Corporation
Santa Fe Industries, Inc.
Southern Pacific Company
Chicago, Illinois

Jean Head Sisco⋆▪
Partner, Sisco Associates
(management consultants)
Washington, D.C.

W. John Swartz•
Vice Chairman
Santa Fe Southern Pacific
Corporation and
President
Santa Fe Industries, Inc.
Chicago, Illinois

Edward F. Swift○
First Vice President,
E.F. Hutton and Company, Inc.
(investment banker and broker-dealer)
Chicago, Illinois

Robert H. West⋆○
President and Chief Operating Officer
Butler Manufacturing Company, Inc.
(manufacturer of prefabricated
buildings and storage facilities)
Kansas City, Missouri

Arthur W. Woelfle•○
Retired Vice Chairman
Dart & Kraft, Inc.
(diversified manufacturer and marketer
of food and consumer products)
Northbrook, Illinois

Kathryn D. Wriston○◆
Director of various corporations
New York, New York

• Executive Committee
⋆ Compensation and Benefits Committee
○ Audit Committee
◆ Nominating Committee
▪ Pension Committee

Corporate Officers

John J. Schmidt
Chairman and Chief Executive Officer

Robert D. Krebs
President and Chief Operating Officer

Alan C. Furth
Vice Chairman

W. John Swartz
Vice Chairman

Orval M. Adam
Vice President, Treasurer and
Chief Financial Officer

William R. Denton
Vice President and
Chief Administrative Officer

C. Ore Davis
Vice President-Human Resources

Glenn W. Dodd
Vice President and Controller

Jerome F. Donohoe
Vice President-Law

Frank N. Grossman
Vice President–
Corporate Communications

Thomas I. McKnew, Jr.
Vice President, Washington, D.C.

Richard B. Bonneville
Secretary

Corporate Information

Principal Subsidiary Companies

Transportation Group

The Atchison, Topeka and Santa Fe Railway Company

Southern Pacific Transportation Company
St. Louis Southwestern Railway Company

Santa Fe Pacific Pipelines, Inc.
Southern Pacific Pipe Lines, Inc.
Santa Fe Pipeline Company
Gulf Central Pipeline Company
Black Mesa Pipeline, Inc.

Pacific Motor Trucking Company

Real Estate Group

Santa Fe Pacific Realty Corporation
Southern Pacific Land Company
Santa Fe Land Improvement Company
Southern Pacific Development Company
Southern Pacific Industrial Development Company

Natural Resources Group

Santa Fe Energy Company
Santa Fe Energy Products Company

SF Minerals Corporation
Santa Fe Mining, Inc.
SF Coal Corporation

Forest Products Group

Kirby Forest Industries, Inc.
Santa Fe Pacific Timber Company

Services and Construction Group

Bankers Leasing and Financial Corporation

Robert E. McKee, Inc.

Annual Meeting
The annual meeting of stockholders will be held in the Great Hall of the Americana Congress Hotel, 520 South Michigan Avenue, Chicago, Illinois, on Tuesday, April 22, 1986 at 10:00 A.M.

Shares Listed
New York Stock Exchange
Midwest Stock Exchange
Pacific Stock Exchange
Ticker Symbol: SFX

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224 South Michigan Avenue
Chicago, Illinois 60604
(312) 786-6000

Registrar of Stock
Morgan Guaranty Trust
Company of New York
23 Wall Street
New York 10015

Transfer Agent
H.R. Huber
Santa Fe Southern Pacific
Corporation
120 Broadway
New York 10271
(212) 962-3111

Dividend Reinvestment
Santa Fe Southern Pacific Corporation provides an automatic dividend reinvestment service to stockholders as a convenient method of investing Company dividends. If you would like a booklet describing this service, please write the Transfer Agent.

Form 10-K and Fact Book
To receive without charge a copy of the Company's Form 10-K annual report to the Securities and Exchange Commission and the Company Fact Book containing financial and statistical information write:

Richard B. Bonneville
Secretary
Santa Fe Southern Pacific
Corporation
224 South Michigan Avenue
Chicago, Illinois 60604

Design: Boller/Coates/Spadaro, Ltd.

Santa Fe Southern Pacific Corporation
224 South Michigan Avenue
Chicago, Illinois 60604